TAX REFORM ACT OF 1975

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

H.R. 10612

AN ACT TO REFORM THE TAX LAWS OF THE UNITED STATES

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TAX REFORM ACT OF 1975

MONDAY, MARCH 29, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Herman E. Talmadge, presiding.

Present: Senators Talmadge, Byrd, Jr. of Virginia, Curtis, Hansen, Dole, and Packwood.

Senator TALMADGE. The committee will please come to order.

The first witness this morning is Hon. Joseph E. Karth, Fourth District of Minnesota. We are delighted to have you before the Finance Committee.

STATEMENT OF HON. JOSEPH K. KARTH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. KARTH. Thank you very much, Mr. Chairman. I did not expect to be recognized so soon. I appreciate it very much.

Mr. Chairman, I want to be very brief.

Senator TALMADGE. If you see fit, you may insert your full statement in the record and summarize it in your testimony.

Mr. KARTH. I appreciate that very much, Mr. Chairman, and I intend to do that.

Briefly, I want to talk to the committee about the experience I recently had as I attended a meeting which was held in Geneva, Switzerland where the EC countries complained against the DISC.

Let me, Mr. Chairman, say to you that if I had not already been convinced that DISC was worth retaining as at least the House has retained it in the recently passed House bill, I would certainly have been convinced that DISC is worth retaining after having listened to the presentation of the EC countries in their complaint against DISC at the GATT hearing that I have just referred to.

As you are aware, the GATT Council at the request of the European Community convened a panel for the purpose of studying GATT and to consider whether or not there had been violation of the anti-export subsidy provisions of GATT article 16. That is, the DISC is an export subsidy and such subsidy results in American products being sold abroad more cheaply than they are sold here at home. That is basically the EC complaint against the DISC.

The United States has counterclaimed against France, Belgium, and the Netherlands, as you know, as also being in violation of those kinds of provisions of the GATT and in more ways and to even greater degrees.

During these deliberations which began 2 weeks ago today, there were many formal and legal arguments concerning which country had the burden of proof and whether the DISC law provides a subsidy. That is, the United States has argued there is no subsidy since the DISC provisions provide for a tax deferral rather than a tax exemption, but it is the EC complaint and claim that it does in fact provide a subsidy, and it does in fact provide an opportunity for U.S. manufacturers to sell abroad cheaper than they sell similar products at home.

But it is my very strong personal judgment, Mr. Chairman, that what the EC members and what leaders of other countries are worried about is the future promise DISC holds; that U.S. businesses will greatly increase their efforts to export more and more of their production to our trading partners rather than exporting more of our jobs to these countries. They are worried that a continuation of DISC as well as continuation of expansion of DISC corporations will lead to a lack of expansion of U.S. multinational companies abroad in their own countries which will result in a failure to create new production facilities in those countries. This would, of course, result in the U.S. multinational corporations providing fewer jobs there than they either desired or expected.

During my brief visit to observe these panels hearings, I was impressed by the fact that the effect of our DISC law on foreign employment seemed to be the dominant motive behind the GATT complaint and the aggressive actions of our trading partners. These proceedings, as I said, were started in 1973, but they were delayed, according to the official explanations, due to procedural difficulties. I believe the delay was due in part to the belief of our partners, reinforced by statements and actions in and out of Congress during 1973 and 1974, that DISC would be repealed. When it became clear at the end of last year that the Ways and Means Committee was going to adopt my proposal for modification rather than repeal, I believe that EC and other interested countries decided to proceed vigorously with their complaint. I assure you these countries intend to pursue the DISC complaint with every available legal means at their disposal, and are obviously already doing so with great determination.

That is why I think they delayed bringing their complaint as far as they now apparently intend to bring it, and that is to fruition.

In fact, it may be the incremental approach that scares them more than the present law. I really do not know, but it does offer an incentive to U.S. export companies to continue to improve their export market. As I said, I can assure you that these countries intend to pursue the complaint with every means at their disposal.

If it is determined finally that DISC is indeed a violation of the GATT agreements with our trading partners, then we will obviously have to consider alternatives and other legal means to stimulate continued and increased levels of exports of U.S.-made products and not U.S. jobs. In the meantime, however, I urge this committee to consider as a very minimum, Mr. Chairman—as a very minimum—adopting the House-passed modification to the DISC law.

I really honestly, thoroughly believe after long and arduous study and after my trip to Geneva and listening for nearly 1 week to the presentations made by the EEC countries, and I am firmly convinced, Mr. Chairman, that the DISC does in fact benefit greatly U.S. corporations and does encourage them greatly to make the product here, to invest their money here, to build plants and install equipment here, to employ U.S. workers in the United States and to export the product rather than exporting the job. I honestly and fervently believe that, and I would hope the Senate committee would at the very minimum, as I have already said, and I don't want to appear to be repetitious or redundant, but I think it very important that you not go beyond what the House has passed in diluting DISC.

Senator TALMADGE. You know virtually all the EEC countries have a value-added tax, do they not?

Mr. KARTH. Yes, they do.

Senator TALMADGE. Then they rebate the tax to all of their exporters, do they not?

Mr. KARTH. Yes, they do.

Senator TALMADGE. That is a greater aid to exports as opposed to the DISC deferrals.

Mr. KARTH. According to the best calculations we are able to make, the DISC is 3 to 5 percent what VAT gives the EEC countries in terms of export benefits.

Senator TALMADGE. Three to five percent out of a total of 100 percent of the value-added tax?

Mr. KARTH. That is the way we have calculated it. We may have made a mistake in our arithmetic, but if we did, it is a minor one.

As you know, we made a very long and exhaustive study of the other benefits that our trading partners—and I don't want to refer just to the EEC countries but EEC countries and other trading partners—give to trading companies and their exporters. We find there is almost an inexhaustible number of benefits of all kinds given. For example, all taxes are given by many countries that make for export. But, at any rate, there is a list that I would like to submit for your record, if I may.

Senator TALMADGE. Without objection, it will be inserted in the record.

Mr. KARTH. I will have to prepare it and put it in comprehensive language, but I would like to do that.

[The list follows:]

TAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Taxation of foreign branch income	Fully taxed at usual rate (progressive rates from 30% to 55%). Deduction for foreign taxes paid. Foreign tax credit upon application.	Exemption of 2/3 of income (effective tax rate of 17.4%).	Exempt except if has not been taxed abroad (tax rates from 47.5% to 50%).	Fully taxed at usual rate (tax rates are from 20% to 45%). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52%). Favorable foreign tax credit system.	Fully taxable at usual rate (46%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, but under conditions less stringent than under subpart F income.
Deductibility of foreign branch losses	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Exempt if at least 25% control.	Exempt if at least 25% control. One-third taxable in other cases.	Exempt in practice.	Exempt.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50%). Partial exemption from 1976. Foreign tax credit.
Special deferrals of taxable domestic income	Investment reserves.	None.		None.	Income may be deferred for: --overseas market development --overseas investment losses --foreign exchange losses	None.
Specific export tax incentives	10% write-off with respect to acquisition of shares in certain foreign entities. Custom free zones.	None.	Deductions and rebates for export market development expenses.	Deduction of 150% of the cost of export related expenditures. Deduction of an amount related to increased export sales.	--Reserves for overseas market development--Deduction of overseas investments. --Reserves for foreign exchange losses. --Special deductions for certain overseas transactions.	None.
Intercompany pricing rules					Favorable treatment for exporting companies.	
Border tax adjustments (VAT)	VAT (rate 16%) zero rate on exports.	None.	None.	None.	None.	None.
Tax incentives indirectly benefiting exports	Accelerated depreciation or tax-exempt investment reserve (1)	Reduced tax rate or exemption from taxation for introduction of new products or processes. Accelerated depreciation.	None.		None.	Tax reduction for manufacturing income. Accelerated depreciation. (1) Investment tax credit.

(1) Most of the tax incentives are granted in connection with industrial and regional development.

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Chart I
Page 2

TAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Taxation of foreign branch income	1/4 the usual rate (48%).	Exempt (1) (corporate tax rate is 50%)	Normal tax rate (51%) plus foreign tax credit or, in certain cases, imposition of a flat 25% tax rate.	Taxed at usual rate (30%). Foreign tax credit.	Exemption on 50% of income (progressive tax rate from 20% to 40%). Foreign taxes deductible.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None except if election is made. No subpart F income equivalent.	Yes, but under conditions less stringent than the U.S. subpart F provision.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.
Deductibility of foreign branch losses	Fully deductible even though foreign income is exempt under tax treaty.	Not deductible. (2)	Fully deductible even though foreign income is exempt under tax treaty. (3)	Fully deductible.		Fully deductible.
Taxation of foreign source dividends	Permanent participation (held for more than one year): 95% exclusion plus 5% tax credit. Non permanent participation: 15% tax credit.	95% exclusion if French company owns 10% or more of the stock.	Fully taxed at usual rate. Foreign tax credit and deemed paid foreign tax credit under certain circumstances.	Fully taxed at usual rate. Foreign tax credit.	50% exclusion if at least 25% control. Total exemption for holding companies. Foreign taxes deductible.	Exempt in majority of cases.
Special deferrals of taxable domestic income	None.	Income may be deferred for:--losses of certain foreign business--cost of investment in certain business in LDCs--export credit extended to foreign buyer.	Income may be deferred for:--losses of foreign branches whose income is tax exempt--losses of foreign subsidiaries--profits realized upon an exchange of property for stock of a foreign corporation.		None.	None.
Specific export tax incentives	None.	--Joint export programs--Election to compute income on a worldwide basis--All special deferrals--Exclusion from the "inflation levy".	None.		None.	Tax credit for withholding tax on interest and royalties paid by residents in certain non-treaty LDCs.
Intercompany pricing rules	Will provide assurances on allocation in certain cases. Historically generous to exporters.	As a general rule, not enforced against exporters.	Usually enforced although relaxation may be granted in special circumstances.			Usually enforced but special agreement used. May be negotiated with the tax authorities.
Border Tax adjustments (VAT)	VAT (18% rate) up to 25% for luxury items. Zero rate on exports.	VAT (20% rate) up to 33% for luxury items. Zero rate on exports.	VAT (11% rate). Zero rate on exports.	VAT (12% up to 30% for luxury items). Zero rate on exports.	VAT (rate 10%). Zero rate on exports.	VAT (16% rate). Zero rate on exports.
Tax incentives indirectly benefiting exports	--accelerated depreciation --exemption from real estate tax --reduced income tax rate on certain reinvested profits (4)	--accelerated depreciation --exemption from local business tax --reduction of registration taxes (4)	--accelerated depreciation --reduction of corporate tax rate and VAT rates (4)	Tax exemption or reduction for financial or government owned companies (4)	In[illegible]ment credit from 3% to 9% of cost of certain capital assets.	Accelerated depreciation (4) Investment tax credit from 8% to 10% of cost of certain capital assets.

(1) Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.
(2) Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.
(3) When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.
(4) Most of the tax incentives are granted in connection with industrial and regional development.

Chart I
Page 3

TAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Taxation of foreign branch income	Taxable at usual rate (52%). Foreign tax credit.	Taxable at usual rate. (Average rate 50%). Deduction for foreign taxes paid.	Taxed at half the usual rate (1/2 of 37%). Foreign tax credit.	Exemption on 50% of income (rate is 26.5%).	Taxed at usual rate (effective income tax rate is 54%). Foreign tax credit.	Fully taxable at usual rate (48%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, under subpart F provisions.
Deductibility of foreign branch losses	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Fully deductible.	Fully deductible.		Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate.	Fully taxed at usual rate. Deemed paid foreign tax credit.	Half-exempt if at least 95% control.	Fully taxed at usual rate. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.
Special deferrals of taxable domestic income	None.		None.	Tax free reserves deductible.		About 25% of taxable income may be deferred under the DISC provisions.
Specific export tax incentives	Deduction of business entertainment expenses connected with export activities.	Exemption from corporate taxes on profits attributable to exports of goods produced in Ireland.		Tax free reserves deductible.	Additional deduction for interest charged on export credit.	None, aside from DISC.
Intercompany pricing rules	Not actively used.				Not actively used.	Strictly enforced, including against export industry. Important cases against exporters pending.
Border tax adjustments (VAT)	VAT (8% rate up to 25% for luxury items). Zero rate on exports.	VAT (19.5% up to 36.5% for luxury items). Zero rate on exports.	VAT (15% rate). Zero rate on exports.	VAT (20% rate). Zero rate on exports.	None.	None at Federal level.
Tax incentives indirectly benefiting exports	Favorable rates of depreciation. (1)	Accelerated depreciation. (1)	Tax-free investment reserves constituted by 20% of annual profits. Dissolved after 10 years. (1)	Accelerated depreciation. Tax-free reserves deductible. (1)	Accelerated depreciation. (1)	Accelerated depreciation. Investment tax credit (10%).

(1) Most of the tax incentives are granted in connection with industrial and regional development.

Chart II
Page 1

NONTAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Nontax incentives indirectly bene-fiting exports	Investment allowances (1)		None.			Cash grants. (1)
Financing assistance	Guarantees for medium-term credits. Rate of interest is 7%.				Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5% to 8.75%). Financing of contract value from 48% to 64%. Mixed credits.	
Insurance assistance					Are insured: --production risks --commercial risks --political risks --currency fluctuations --loss of foreign investment. Risks are covered from 60% to 80%.	

(1) Most of the nontax incentives are granted in connection with industrial and regional development.

NONTAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Nontax incentives indirectly benefiting exports	--Interest subsidies --Investment subsidies (1)	--Grants --Investment subsidies (1)	Grants (1)	--Capital grants --Long and medium term loans by specialized government institutions (1)	--Grants --Loans --Guarantees (1)	--Investment subsidies --Interest subsidies (1)
Financing assistance	Discount at low rates. Interest rebates on export credit. Subsidized medium term export financing. Average rate borne by exporters is 9%. Financing of up to 90% of contract value.	Discount at low rates. Long-term loans at 7.5% rate, to both suppliers or buyers. Financing of up to 100% of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10%. Financing of up to 80% of contract value. Mixed credits.	Discount at low rates. Interest subsidies. Long-term loans at 8.95% rate to both suppliers and buyers. Financing of up to 100% of contract value.		Discount at low rates. Guarantees. Subsidized medium and long-term export credits. Average interest rate borne by exporters is 9.5%. Financing of up to 90% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --currency fluctuations Risks covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --market development --exhibition expenses --inflation risks Risks are covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered from 80% to 100%.	Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are 90% covered.		Are insured: --commercial risks --political risks --currency fluctuations Insurance usually covers from 75% to 100% of the risks.

(1) Most of the nontax incentives are granted in connection with industrial and regional development. In Belgium, interest subsidies are granted for the purpose of investment throughout the country and not only in depressed areas.

NONTAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Nontax incentives indirectly benefiting exports	--Grants --Investment subsidies --Interest subsidies (1) --Employment subsidies (2)	--Investment allowances --Training grants --Loan guarantees (1)	--Loans --Cash grants (1)		--Investment allowances --Loan guarantees (1)	None, except limited agricultural subsidies.
Financing assistance	Guarantees. Interest rate subsidies. Portfolio refinancing. Support granted on a supplier and buyer basis. Interest rate borne by borrowers: 7.8%. Financing of up to 100% of contract value. Mixed credits.	Guarantees. Medium-term loans at preferential rates (8%). Financing of up to 80% of contract value.	Guarantees. Financing of up to 90% of contract value. Interest rate is 8.5% after first year.		Medium and long-term financing at 2% or 3% above discount rate. Financing of up to 100% of contract value.	Discount at medium rates. Guarantees. Long-term export credit financing at interest rates from 8.25% to 9.5%. No mixed credits. Financing of 30% to 55% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --production risks --inflation risks --currency fluctuations --performance bonds Risks are covered up to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations Risks are covered up to 100%.	Are insured: --commercial risks --political risks --currency fluctuations Risks are covered from 65% to 90%.		Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered up to 90%.	Are insured: --commercial risks --exhibition expenses --political risks Risks are covered up to 95%.

(1) Most of the nontax incentives are granted in connection with industrial and regional development.
(2) Granted in order to encourage employers to retain employees.

Chart III

TAX INCENTIVES FOR EXPORTS*

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	U.S.
Partial or total exemption on foreign branch income	X	X	X		X				X	X		X		X	X				
Foreign subsidiaries not subject to tax	X	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X		
Foreign branch losses deductible	X		X	X	NA	X	X	X	X	NA	X		NA	NA	X	NA	X	X	X
Partial or total exemption on foreign source dividends	X	X			X	X			X			X	X	X	X	X		X	
Special deferrals of domestic income		X	X	NA				NA		X	NA				NA		X		X
Export tax incentives		X				X	X	X	NA	X	X		X		X	X	X		DISC only
Non-enforcement of intercompany pricing rules	X	X		NA	NA	X	X	NA	NA	NA	X	NA	NA	NA	NA	NA	X		
Border tax adjustments	X	X	X	X	X	X	X	X	X	X			X						

* X indicates country has incentives.
NA indicates that information not available.

Chart IV

NONTAX INCENTIVES FOR EXPORTS*

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	U.S.
Nontax incentives indirectly benefiting exports	X	X	X	X	X	X	X	X	X	NA	X		X	NA		NA	NA	X	
Financing Assistance														NA	NA	NA		NA	
- Rate of interest	9%	7.5%	10%	8.95%	NA	9.5%	7.8%	8%	8.5%	NA	(1)	NA	7%				7.5-8.7%		8.25-9.5%
- Portion of contract value financed	90%	100%	80%	85%	NA	90%	100%	80%	90%	NA	100%	NA	NA				48-64%		30-55% (to buyers)
- Mixed credits		X	X														X		
Insurance Assistance					NA					NA		NA	NA	NA	NA	NA		NA	
- Commercial risks	X	X	X	X		X	X	X	X		X						X		X
- Political risks	X	X	X	X		X	X	X	X		X						X		X
- Production risks		X	X				X	X									X		
- Currency fluctuations	X	X	X	X		X	X	X			X						X		
- Performance bonds							X												
- Market dev-developments		X																	
- Exhibition expenses		X																	
- Inflation risks		X	X	X			X				X								X

* X indicates country has incentives.
NA indicates that information not available.
(1) 2% or 3% above discount rate.

Senator TALMADGE. Thank you for your appearance and contribution.

Senator CURTIS. Is it your testimony that DISC does help business in the United States by creating jobs and that part of the reason you know that this is true is that our competitors abroad were complaining about DISC?

Mr. KARTH. Yes.

Senator CURTIS. Did you hold this opinion of DISC prior to this study that you made abroad, or has the study produced a change in your opinion?

Mr. KARTH. This is a change in my opinion, Senator Curtis. I was not on the Ways and Means Committee when the original DISC law was passed in 1971. But since that time and after becoming a member, I was somewhat critical of DISC. I felt it was not returning the benefit comparable to what it was costing the taxpayers of this country. As a result of that, I took some interest in it. Chairman Ullman knowing my interest in it asked me to make a thorough study.

Senator CURTIS. Were you the author of the incremental provision in the House bill?

Mr. KARTH. Yes; I talked to persons pro and con, those who had something to offer or those who thought they did and in my judgment didn't, but my professional staff and I listened to hundreds of people. I came away at that point in time concluding yes, there was a benefit in DISC that I had overlooked originally.

Then, of course, having studied it at greater length and having gone to Geneva and having witnessed the EEC complaint, I am more convinced than ever that it does promote and stimulate expansion of production facilities in the United States for export of products made here.

Senator CURTIS. And the continuation of DISC means jobs here?

Mr. KARTH. Yes.

Senator CURTIS. Have you changed your mind with respect to the incremental provision added to DISC by the House bill?

Mr. KARTH. I don't know that I changed my mind about it, Senator. Let me just say there is some good and some bad about everything. The incremental approach with the 5-year grace period provides an incentive for U.S. companies to continually increase their export markets whereas the existing laws do not provide that incentive.

Senator CURTIS. Do you agree that there are some administrative problems in applying such a rule on a company-by-company basis?

Mr. KARTH. I don't think there is any question about that.

Senator CURTIS. Also, the incremental approach creates a special problem with reference to a company that has not exported before.

Mr. KARTH. Yes, that is true except they also can build a base period. For small exporters, Senator Curtis, I think you are probably familiar with the fact the House said for those who export $100,000 a year or less they are not subjected to the incremental approach.

Senator CURTIS. As I understand the House bill, the DISC provision would not apply to agricultural exports.

Mr. KARTH. That is true in some respects. The raw, grown foodstuffs and things that do not go through a manufacturing process, for those the DISC benefits would be removed.

Senator CURTIS. I certainly commend you for your testimony here. Your views will be very helpful to the committee. This committee will not, however, be the final authority on this tax bill. We are anticipating quite a floor fight on many of these provisions.

The distinguished Senator from Massachusetts, Mr. Kennedy, appeared before this committee and appears to be leading the fight. Among the other things, he recommends repeal of the DISC provisions. He states that the House bill does restrict the DISC provision somewhat, but he adds the comment that the House failed to repeal DISC entirely, largely because of the barrage of business lobbies. Do you agree with that contention?

Mr. KARTH. Let me say in answer——

Senator CURTIS. I take it your whole testimony is in disagreement with Senator Kennedy's statement?

Mr. KARTH. Let me say the only reason there has been a great deal of talk about repealing it, is because of the barrage of lobbying that has been going on by the so-called-public interest organizations and the AFL–CIO. I guess it is because the DISC does not in their judgment provide benefits for their members. If it does not apply to me, it is a loophole and if it applies to me, then it is something in the code well worthwhile and has great benefit.

Senator CURTIS. This kind of argument does give an out for our friends who favor increased spending. They can tell the public that the Internal Revenue Code is filled with devices that enable rich men to avoid their taxes and that, if they could just reform the tax code, there would be ample money for every spending scheme that can be imagined. Of course, that is not true. Those of us who have examined the situation know that.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. Mr. Karth, I understand the charge has been made that if DISC were repealed, there would be an increase in Federal revenues in excess of $1½ billion.

Mr. KARTH. I disagree with that, Senator.

Senator HANSEN. You have anticipated my question.

I think I have no further questions.

I have some figures. Norman Ture estimates an initial impact loss of revenues, the Treasury would get an increased $7.9 billion. The Manufacturing Chemists Association estimates repeal of DISC would result in a loss of $46,000 and Data Resources, headed by Prof. Otto Eckstein, estimates repeal of DISC would loose 20,000 jobs the first year and 90,000 jobs after the fifth year of repeal, if that may suggest something, it is all yours.

Mr. KARTH. Senator, we looked at all kinds of econometric models and various guesses and estimates by professors and professional people. Obviously, of course, they all come up with different conclusions. But we, my professional staff and I, concluded that there is no doubt whatsoever but that if DISC were repealed, in the long run, the Treasury would probably lose money rather than what it costs the Treasury today in terms of deferral of taxes for those corporations that have formed the DISC. I don't think there is any question at that, Senator. I am thoroughly convinced that is true and that would be the ultimate result if DISC were repealed.

Senator HANSEN. Thank you very much.

Senator TALMADGE. Senator Byrd.

Senator HARRY F. BYRD, JR. Congressman, you favor the continuation of DISC but you favor a modification in the present law.

Why do you favor a change?

Mr. KARTH. I favor a change for several reasons, Senator. First of all, there were some DISC payments that I thought were not earned. They were really a windfall gift for all practical purposes. I don't think there is any real serious argument about that. Whether there was a DISC law or not, they would have exported *x* amount of their products.

I favored the change because under the incremental approach, it appears to me that there is an incentive to continue to not only export but to increase exports. If over a long period of time you did not increase your exports, then you do not benefit to the extent that you do under the present law. That is the reason, sir, that I adopted the incremental approach in my own mind as the best of the two.

You, Senator, may disagree with that.

Senator BYRD. I don't disagree. I was just trying to get your thinking.

Mr. KARTH. The 5-year grace period we give along with this incremental approach does in fact, as you know, give these companies 5 years to increase their exports before that incremental approach formula really applies to them. So, they are always 5 years behind. That seems to me quite a considerable length of time for them to make the extra effort to increase their exports and, as a result of that, benefit from the DISC law.

I think it is good. I think it is healthy. You, sir, and the Senate body over here may disagree with me.

Senator BYRD. I take it that you feel the modifications would improve a law that you think is desirable?

Mr. KARTH. I think it would improve it; yes, I do; but if, on the other hand, you think that it will not, the only thing I would encourage this committee is that you don't throw the baby out with the bath water: that at the very least they adopt the House proposal and if that is unsatisfactory, that you not change the existing law.

Senator TALMADGE. Thank you very much, Congressman. We appreciate your contribution and are delighted to have you before us as a witness.

[The prepared statement of Congressman Karth follows:]

TESTIMONY BY REPRESENTATIVE JOSEPH E. KARTH, FOURTH DISTRICT, MINNESOTA

Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss a matter which occupied a great amount of time during last year's Ways and Means Committee deliberations, and which will certainly prove to be an important topic before your Committee in the months ahead—this being the "DISC" tax deferral provisions.

I was not a member of the Ways and Means Committee when DISC was first enacted in 1971, but I presume I would have supported the proposal given the world economic situation at that time, and the position of the United States in world trade. During the few years after, however, I was one of the many members of our Committee who thought that the provision was rapidly becoming too

costly (in terms of tax expenditures), and was not doing the job originally intended.

As you know, the Committee in 1974 agreed to eliminate DISC for certain types of exports (natural energy resources and agricultural products), and had there been a vote at that time or even in early 1975 to completely eliminate the DISC deferral, I might have supported such a move. DISC seemed then, as it does even now, as an easy target for a tax "reform" effort that would apparently raise some substantial revenues in the short run.

But then, Mr. Chairman, I talked with some of my constituents who have set up and are operating DISC export corporations, and I decided to take a better look at the DISC law, and the manner in which it has been used in the past few years. Now, I really didn't expect any DISC owners to recommend we eliminate or reduce the deferment privilege, but I was interested to learn how companies, large and small, have made use of the DISC provisions.

As you may know, Chairman Ullman of our Committee, knowing of my interest to learn more about DISC, appointed me as a one-man task force to study the DISC experience since it became effective in 1972. During the next few weeks, my professional staff and I together communicated with over 200 separate companies, from the largest DISC owner to some of the smallest, either in person or by letter or phone, to discuss their DISC operations. We talked with the Treasury and Commerce Department representatives who are responsible for DISC matters. We also talked with many persons and organizations, including labor representatives, and public interest groups, who were opposed to continuation of any DISC deferrals. We reviewed the available Treasury Department's annual reports and statistics on DISC operations, as well as the study of DISC prepared for the House Budget Committee's tax expenditure task force. We also reviewed the available information concerning the many and various tax incentives and privileges offered to encourage exporters in other countries.

After considering all the information I had collected and all the conversations I had had, I came to the conclusion that DISC was indeed a valid concept which was worth preserving to the extent it served the purpose of persuading U.S. businesses to continue or begin business ventures within this country rather than abroad. Using the cliche words that are so often associated with DISC, I wanted to maintain the DISC deferral to the extent it was used to convince businesses to export only U.S. production, not U.S. jobs. At the same time, I still agreed that to the extent DISC provided a "windfall" or unnecessary tax advantage to companies without achieving the desirable purposes I have mentioned, DISC should be eliminated.

I considered several alternatives suggested to the Committee by some of the witnesses that appeared last July, as well as some of the suggestions of the representatives of some DISCs. The Treasury Department (which opposed modification of DISC) was extremely helpful to me in supplying data and revenue information for the various alternatives, as was Dr. Woodworth's staff on the Joint Committee.

After putting all this information together, and after reviewing the various versions of the DISC deferral formula as it went through the House and Senate in 1971, I proposed that the Committee adopt a formula for computing DISC deferral which in effect (1) eliminated DISC altogether for most agricultural and military sales exports, (2) modified the existing DISC provisions for manufacturing exports to preserve about 65% of the present deferral privilege, and (3) provided some incentives to small DISC corporations and newly created DISCs so that such entities would not be discouraged from entering the export market.

I will not elaborate here on the details of the formula, because I'm sure Dr. Woodworth and his staff will be explaining it to you very carefully when you reach that topic for markup. But basically, the present deferral of tax on 50% of qualifying export profits would only be applicable to profits from those export sales that exceed ¾ of such sales during a previous period. The main objective of such a formula (called the "incremental approach") is to allow the deferral privilege only for export sales that to an appreciable extent exceed the level of export sales already achieved in a previous period. Thus, DISC would provide more of an incentive to increase qualifying exports each year than present law provides, and would eliminate the "fat" or windfall in the present law to the

extent it rewards exporters each year for continuing existing levels of exports which they would undoubtedly want to continue anyway.

Mr. Chairman, as I stated at length in the Ways and Means Committee, and again on the floor of the House, I sincerely believe the intended purpose and actual application and effectiveness of the DISC provisions has not been correctly understood. I believe I was able to persuade more than a majority of our Committee to examine the DISC provisions seriously and carefully in light of the available data and information, and to agree to modify DISC only in accordance with the new formula I proposed.

As if I wasn't already convinced that DISC was worth retaining in part as I have described, I would have certainly been convinced after my recent visit to Geneva as a Congressional observer at the GATT panel hearings on the legality of our DISC provisions under the GATT rules.

As you are aware, the GATT Council, at the request of the European Community (EC), convened a panel on July 30, 1973, to consider the EC's complaint against the DISC provisions, as being inviolation of the anti-export subsidy provisions of GATT Article XVI. That is, that DISC is an export subsidy, and that such subsidy results in American products being sold abroad cheaper than here at home. The U.S. had counterclaimed that certain tax practices of Belgium, France and the Netherlands also violated these provisions of the GATT.

Now during these deliberations which began two weeks ago today, there were many formal and legal arguments concerning which country had the burden of proof, and whether or not the DISC law provides a "subsidy" (The U.S. has argued there is no subsidy, since DISC provides a deferral of tax, rather than an exemption).

But it is my very strong personal judgment, Mr. Chairman, that what the EC members and presumably other countries are worried about, is that the future of DISC hold such promise, that U.S. businesses will greatly increase their efforts to export more and more of their production to our trading partners, rather than our jobs. They're worried that a continuation of DISC as well as continued expansion of DISC corporations will lead to a lack of expansion by the U.S. multinationals abroad which will result in failure to create new production facilities in their countries. This would, of course, result in U.S. multinationals providing-fewer jobs in those countries than they desire or expect.

During my brief visit to observe these panel hearings, I was impressed by the fact that the effect of our DISC law on foreign employment seemed to be the dominant motive behind the GATT complaint and the aggressive actions of our trading partners. These proceedings, as I said were started in 1973, but were delayed, according to the official explanations, due to procedural difficulties. I believe the delay was due in part to the belief of our partners (reinforced by statements and actions in and out of Congress during 1973 and 1974) that DISC would be repealed. When it became clear at the end of last year that the Ways and Means Committee was going to adopt my proposal for modification rather than repeal, I believe the EC and other interested countries decided to proceed vigorously with their complaint. I assure you these countries intend to pursue the DISC complaint with every available legal means at their disposal, and are obviously already doing so with great determination.

If it is determined finally that DISC is indeed a violation of the GATT agreements with our trading partners, then we will obviously have to consider alternatives, and other legal means to stimulate continued and increased levels of exports of U.S. made products and not U.S. jobs. In the meantime, however, I urge this Committee to consider, as a very minimum, adopting the House-passed modification to the DISC law.

Senator TALMADGE. The next witness is the Honorable Jaime Benitez, Resident Commissioner of Puerto Rico, accompanied by Salvador Casellas, secretary of the treasury of Puerto Rico and Teodoro Moscoso, administrator, Economic Development Administration of Puerto Rico.

Gentlemen, we are happy to have you with us and, Commissioner, if you desire to do so, you can insert your full statement and summarize it, sir.

STATEMENT OF HON. JAIME BENITEZ, RESIDENT COMMISSIONER OF PUERTO RICO, ACCOMPANIED BY SALVADOR CASELLAS, SECRETARY OF THE TREASURY OF PUERTO RICO, AND TEODORO MOSCOSO, ADMINISTRATOR, ECONOMIC DEVELOPMENT ADMINISTRATION OF PUERTO RICO

Mr. BENITEZ. As the Chairman indicated, my name is Jaime Benitez. I represent Puerto Rico in the U.S. Congress, and I am accompanied by the secretary of the treasury of Puerto Rico, Mr. Salvador Casellas, and the former U.S. Ambassador to Venezuela and presently administrator, Economic Development Administration of Puerto Rico, Mr. Teodoro Moscoso.

We come before you, gentlemen, in support of the Tax Reform Act of 1975 and for the implementation of H.R. 10612 insofar as it includes under section 1051 a revised version of section 931 known now as 936.

We come here because the approval of this section constitutes one of the few rays of hope for a potential amelioration of the extremely critical problem of employment and income presently choking industrial development in Puerto Rico. The reason for our support, as well as the explanation of critical conditions prevailing in Puerto Rico, will be discussed respectfully by the two highest officials of Puerto Rico directly concerned with finance and industrial development.

The recent testimony which you have been kind enough to advise us will be included in full in the record, covers adequately our position in conformity with what the chairman has said. We will briefly summarize what the situation is.

I may merely add on my own that no place under the American flag has been more dismally affected by the inflation, recession and the quadrupling of petroleum prices than Puerto Rico. Puerto Rico is essentially a trading post where we import what we consume and export what we produce.

Our sole source of energy is imported petroleum. Our principal market both for sales and purchases is the United States.

As a result of a combination of these several factors, our consumer price index has gone up 33 percent.

Unemployment stands officially at 21 percent. Unofficially it is much higher.

Our income has been significantly reduced and it has been decided to implement the most stringent measures to comply with the requirement for a balanced budget each year laid down by the Constitution of Puerto of Rico. We are caught in the double vise of Federal minimum wages and coastwise shipping laws.

As section 936 pertains to Puerto Rico's corporations, it provides an impotrant improvement from the standpoint of Puerto Rico and from the standpoint of the United States.

The secretary of the treasury of Puerto Rico now, with your permission, will explain our position.

Mr. CASELLAS. We want to thank the committee for affording us the opportunity to appear before you today. The Commonwealth of

Puerto Rico strongly urges the addition of section 936 to the Internal Revenue Code through the enactment of section 1051. Under the present law which has been in effect for more than half a century, a U.S. corporation actively engaged in a trade or business in Puerto Rico is exempt from income taxes on its income from sources outside the United States if it derives at least 80 percent of its gross income from sources within Puerto Rico and 50 percent from the active conduct of the trade or business in Puerto Rico.

The House Ways and Means Committee, after determining that it was inappropriate to disturb the existing relationship between the investment incentives and the U.S. tax laws, recommended certain changes in the existing law designed to assist Puerto Rico in obtaining employment by U.S. investments while at the same time, encouraging those corporations to bring back to the United States the earnings from these investments to the extent that they cannot be reinvested productively in the Commonwealth. These are the changes embodied in the section 936.

Under these provisions, qualified U.S. corporations operating in our Commonwealth would be taxed on their worldwide income but would receive a full credit for U.S. taxes on business and qualified investment income earned in Puerto Rico whether or not a tax is paid to Puerto Rico. As concluded by the Ways and Means Committee, the exemption of the income from sources outside the United States and outside of Puerto Rico does not contribute to the economy of Puerto Rico or to the economy of the United States.

The proposed section 936 provides a deduction to the U.S. payment of dividends received from a qualified subsidiary in the United States to permit current repatriation of earnings tax free. The present denial forces a U.S. subsidiary to place this investment abroad until such time as the company is liquidated or until such time as it can be returned to the United States. These investments are not available in the United States or Puerto Rico while they are, outside of both countries.

Favorable provisions in the Federal income tax laws are necessary to achieve the further industrialization of our economy.

Puerto Rico is making our contribution to this objective by matching these Federal tax incentives with incentives of our own. This partnership in opportunities has served well the common purpose of the United States and Puerto Rico.

The proposed section 936 would in summary do two things for Puerto Rico, it would make more attractive our industrial incentives so that we can promote employment in Puerto Rico; for the United States, it would harness income that is presently outside of the United States and outside of Puerto Rico and refund, rechannel it into the economy of both countries. Right now that income is outside of both jurisdictions.

The present situation in Puerto Rico amply justifies the changes that this section undertakes to achieve.

Mr. Moscoso. Mr. Chairman and members of the committee, I am Teodoro Moscoso, economic development administrator. I believe I have testified in front of several members ot this committee before in connection with the Alliance for Progress in Latin America. I now wish to very briefly give you the essential characteristics of the Pureto Rican economic situation.

We have an extraordinary population density, rapid population growth, very high unemployment, substantial poverty and a heavy dependence on trade and investments.

As a result, the combined pressures of inflation and recession have been more profoundly damaging to the island than to the mainland.

As you know, the island is 100 miles long and 35 miles wide and considerably smaller than the State of Connecticut. Seventy-two percent of the land mass has a slope of over 15 degrees, so the amount of available land is very small. It amounts to less than two-tenths of an acre of crop per inhabitant as compared to 1.9 acres in the United States.

Other natural resources consist primarily of the climate, some beaches, limestone and low-grade copper deposits, which have only become economic to exploit in recent years.

Despite extensive outmigration in 1950 and 1960, as of January 1976, the population had grown to 3,163,000 people or 925 persons per square mile versus mainland density of 59 persons per square mile. It makes Puerto Rico one of the most densly populated areas in the world. Although the Commonwealth has undertaken a vigorous program of family planning, the population is expected to grow, the working population, by 560,000 in the next decade.

Senator TALMADGE. I am sorry your time has expired. I wish we had more time but there is a multiplicity of witnesses waiting behind you.

Senator CURTIS. I have had occasion to inquire into this proposal, I think the House has given us a good proposal. I believe we should adopt it. The existing law is doing something concrete to promote employment in Puerto Rico, and I think what the House has proposed is necessary to make that operation complete and continuing and successful. Due to the shortness of time, I won't have any questions about it, but I favor your proposition.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. I have no questions.

Senator TALMADGE. Senator Byrd.

Senator HARRY F. BYRD, Jr. I have no questions.

Senator TALMADGE. Senator Packwood.

Senator PACKWOOD. I have no questions.

Senator TALMADGE. Thank you very much, gentlemen.

[The prepared statement of Mr. Benitez follows:]

STATEMENT OF HON. JAIME BENITEZ, RESIDENT COMMISSIONER OF PUERTO RICO

Mr. Chairman and members of the Finance Committee, we thank the Committee for affording us the opportunity to appear and discuss with you the provisions of proposed Section 936 of the Internal Revenue Code, as contained in Section 1051 of H.R. 10612 and relating to the treatment of corporations conducting a trade or business in Puerto Rico.

The Commonwealth strongly urges the addition of Section 936 to the Code through the enactment of Section 1051. The Commonwealth believes that these provisions, which were approved by the House of Representatives after thorough consideration by the House Ways and Means Committee, will contribute markedly to the increase of employment in Puerto Rico and make available additional funds for investment in the United States.

Under the present law, which has been in effect for more than half a century, a U.S. corporation actively engaged in a trade or business in Puerto Rico is exempt from Federal income taxes on its income from sources outside the United States if it derives at least 80% of its gross income from sources within Puerto Rico and 50% of its gross income from the conduct of such trade or business. (Section 931 of the Internal Revenue Code).

In its report on H.R. 10612, the Ways and Means Committee concluded: "It is inappropriate to disturb the existing relationship between the possession investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries. The U.S. Government imposes upon the possessions various requirements such as minimum wage requirements and requirements to use U.S. flagships in transporting goods between the United States and various possessions, which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations." (Report No. 94-658 of November 12, 1975, pages 254-255)

The House Ways and Means Committee, however, recommended certain changes in the existing law, designed to assist Puerto Rico in obtaining employment-producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments, to the extent that they cannot be reinvested productively in the Commonwealth. These changes are incorporated in proposed Section 936.

Under the provisions of this section, qualified U.S. corporations operating in Puerto Rico are to be taxed on world wide income, but will receive full credit for U.S. taxes on business and qualified investment income earned in Puerto Rico whether or not a tax is paid to Puerto Rico. As concluded by the Ways and Means Committee, the present Federal tax exemption of such corporations on income from sources outside of Puerto Rico does not contribute significantly to the economy of the Commonwealth.

Moreover, the income derived from liquidating these corporations will continue to be exempt from U.S. taxes under Section 332 of the present law, which is retained. In addition, the proposed Section 936 also provides for a deduction to the U.S. parent corporation of dividends received from a qualified subsidiary in Puerto Rico, so as to permit current repatriation of earnings tax free. The present denial of a deduction for dividends paid to a parent corporation, forces the Puerto Rican subsidiary to invest this income abroad until such time as it is liquidated, when it can be returned to the United States tax free. These accumulated business profits are not available for investment in the United States and the income produced (under the present law) is not subject to U.S. tax.

The Ways and Means Committee felt that these basic changes would provide for "a more efficient system for exemption of possessions corporations." For the convenience of the Finance Committee, we attach pertinent provisions of Report 94-658.

Favorable provisions in the Federal income tax laws for Puerto Rico are absolutely necessary to achieve the further industrialization of our economy. In turn this industrialization is indispensable to create the job opportunities which our people so badly need. Puerto Rico has made its contribution to this objective by matching Federal tax incentives with incentives of its own. This partnership in opportunities has served well the common purpose of the U.S. and Puerto Rico. Although we still have a long way to go, we have made significant progress under our economic development program. However, Puerto Rico suffers from severe natural disadvantages, increasing competition in its principal market, and has been severely buffeted by inflation and recession. In fact, the present recession has affected Puerto Rico much more than the U.S.

As a result, Puerto Rico's economy urgently needs the additional boost which it would receive from adoption of the proposed Section 936. This is well supported by the facts of Puerto Rico's current economic and fiscal situation.

THE ECONOMIC AND FISCAL SITUATION OF PUERTO RICO

The essential characteristics of Puerto Rico's economic situation are scarcity of natural resources, extraordinary population density, rapid population growth, very high unemployment, substantial poverty and a heavy dependence on external trade and investment. As a result, the combined pressures of inflation and recession have been more profoundly damaging to the Island than to the mainland.

Puerto Rico is approximately 100 miles long and 35 miles wide with a total area of only 3,421 square miles, considerably smaller than the state of Connecticut.

The Island lies some 1,600 miles southeast of New York and 1,000 miles southeast of Miami.

Seventy-two percent of the land has a slope of over 15 degrees and is not suitable for conventional development or mechanized agriculture. Fifty-six percent

is mountainous or steeply sloped with a grade of over 35 degrees. Of the total area, 14 percent, mainly in the lowlands, is subject to flooding. Only 24 percent is in cropland, and some of this land should not be farmed. As a result, less than two-tenths acre of cropland is available per inhabitant, compared with 1.9 acres in the United States.

Other natural resources consist primarily of the climate, some beaches, limestone and low-grade copper deposits, which have only become economic to exploit in recent years. There are geological indications of possible petroleum deposits in very deep offshore waters, but their existence is uncertain as no wells have been drilled.

Despite extensive outmigration in 1950's and 1960's, as of January 1976, the population had grown to 3,163,000 or 925 inhabitants per square mile, versus 59 per square mile on the mainland, making Puerto Rico one of the most densely populated areas in the world. Although the Commonwealth has undertaken a vigorous program of family planning, the working age population is expected to grow by 463,000 during the next decade, due in part to a return migration which has added 145,000 persons to the population in the last four years. Many of these returnees have undoubtedly been affected by job competition from the 10 million foreigners illegally residing in the United States.

Unemployment has always been serious and chronic. Due to the recession it has not only jumped to record levels, but it will take us at least five years to get back to our "normal" rate of 12%!

After declining from 15% in 1940, the unemployment rate hovered between 10% and 13% for fifteen years through 1974. In addition to the factors mentioned, 225,000 low wage jobs were lost in agriculture and home needlework. Only outmigration and rapid industrialization averted social disaster.

Then as a result of the latest recession, the unemployment rate climbed to 19.9% in August 1975 and a record 21.9% in January 1976, higher than that of any State.

Due primarily to the industrial development program, real per capita personal income has tripled in the last generation. Nevertheless, average income levels in Puerto Rico are still far below comparable figures for the U.S. or any state. Puerto Rico's per capita personal income was only $1,986 in fiscal year 1974, 38% of the U.S. average and 54% of the average for Mississippi, the lowest ranking state. Over half our families have incomes below the Federal poverty level.

Given these conditions and our small internal market, Puerto Rico is heavily dependent on external trade to achieve economic growth. In fiscal year 1975, merchandise exports amounted to $3.1 billion, including shipments to the United States of $2.7 billion. Imports for the same period were almost $5 billion, including $3 billion of shipments from the United States to Puerto Rico. Thus our total external trade amounted to $8.1 billion or 114 percent of our gross product of $7.1 billion, a "coefficient of external trade" which is higher by far than that of most industrialized countries, including small ones such as Belgium, Holland, Luxemburg and Switzerland. The corresponding ratio for the United States is only 14 percent. In this regard, it is noteworthy that Puerto Rico depends on imports for 99% for its energy (derived from foreign petroleum) and for 60% of its food.

This dependence has injected a much stronger dose of inflation into our economy than that experienced by the mainland. In the last three fiscal years, our consumer price index rose 33% versus 26% on the mainland. Overall, the cumulative cost of this inflation to our economy was over $1.1. billion in 1975.

To create a high level of economic activity, we have had to rely heavily on external investment. During the period of 1951–75, externally held, long-term investments in Puerto Rico, provided over half of total investment in construction, machinery and equipment. Direct investments by private enterprise, principally U.S. manufacturing firms, supplied nearly a third of the total.

Despite this investment, the recession took its toll of production as well as employment. In each of the last two fiscal years, the real gross product per capita of Puerto Rico declined, at an average rate of 3.0% compared to a traditional real increase of 5%.

Inflation and recession also had a serious impact on government revenues.

To satisfy the Constitutional requirement of a balanced budget, the government for the past two fiscal years was forced to resort to extreme austerity measures, including:

1. Governmental outlays were sharply curtailed. To this end, employment and salary freezes were put into effect; operating expenses were reduced substantially and purchases of new equipment were completely banned.

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2. The proposed budget for fiscal year 1977 of $1.8 billion is $157 million less than the current budget.

To achieve this reduction, salary increases for all Government employees scheduled to become effective in fiscal 1976 on the basis of existing legislation were cancelled.

3. To bolster revenues, the following major tax measures were adopted:

(a) Excise taxes on gasoline, cigarettes, alcoholic beverages and horse racing prizes were substantially increased.

(b) Real property taxes were more than doubled and the corporate income tax and insurance premium tax were increased. In addition, a new basis for the taxation for the income of foreign life insurance companies, producing higher yields, was adopted and the 50 percent income tax exemption granted to savings and loan associations was repealed.

(c) A 5 percent general excise tax was levied on all goods not previously taxable in Puerto Rico, with the exception of food, medicine and some minor items.

(d) A temporary surtax on net taxable income was imposed at rates ranging from 1 to 5 percent during calendar years 1974, 1975 and 1976. Puerto Rican personal income tax rates now exceed Federal rates at nearly all levels of income.

(e) A franchise tax on financial institutions to be levied at a rate of 12 percent in calendar 1975, 17 percent in calendar 1976 and 22 percent thereafter.

(f) A temporary 2 percent surtax on corporate income for tax years ending before December 31, 1975.

These taxes constituted an additional tax effort of 14.1 percent in fiscal 1974 and of 18 percent in fiscal 1975. For the Federal Government to match this, it would have to levy new taxes yielding more than $35 billion for fiscal 1976.

IMPORTANCE OF MANUFACTURING IN THE PUERTO RICAN ECONOMY

Puerto Rico does not seek a fair distribution of poverty. It is our fundamental aim, not only to create jobs, but to provide a decent standard of living for all our people. Moreover, we want to create work and dignity for Puerto Ricans in Puerto Rico. We do not want our people to become basket welfare cases, dependent on Federal handouts as the only way to survive. Food stamps are fine for those who are down or out, but they should not become a way of life for those who can work. Nor do we want our people to be forced to exercise their birthright as U.S. citizens to relocate elsewhere in these United States, merely to secure meaningful employment at a severe cultural and social cost.

Given these objectives plus our lack of natural resources, small internal market, island location, and consequent dependence on external trade, our economy has only three basic sectors: manufacturing, agriculture and tourism. The great bulk of other economic activity depends on these in the long run, and the greatest opportunities to create jobs are in manufacturing.

In fiscal 1975, average employment in Puerto Rico was 738,000 of which manufacturing provide 137,000 or 19 percent, agriculture 49,000 or 7 percent and expenditures by visitors to Puerto Rico provided the equivalent of 20,000 direct jobs or 3%. During the same year 30% of Puerto Rico's gross product and net income originated in the manufacturing sector. Manufacturing was also responsible for practically all of Puerto Rico's merchandise exports.

Preliminary results from a revision of the Puerto Rico Planning Board's mathematical model of the Puerto Rico economy indicate that the long range employment multiplier of direct manufacturing employment is still close to 3.0. That is for every direct job created in the manufacturing sector, roughly two jobs are eventually created in the rest of our economy. On this basis and despite the recent recession, manufacturing accounted for over 400,000 direct and indirect jobs in fiscal year 1975 or roughly 55% of total employment.

Over the years, the economic success of manufacturing operations in Puerto Rico led, in the first place, to the continued expansion of existing operations and secondly, to convincing other manufacturing firms to consider Puerto Rico as a viable place for bona fide expansions.

IMPORTANCE OF THE INDUSTRIAL DEVELOPMENT PROGRAM FOR MANUFACTURING SECTOR

Most of the jobs in the manufacturing sector have been created by the industrial development program operated by "Fomento", the Economic Development Administration of the Commonwealth of Puerto Rico.

Fomento's principal mission is to convince investors and manufacturers, in the United States, Puerto Rico or elsewhere, to establish new manufacturing plants in Puerto Rico; to assist them in establishing these plants and then help these plants grow and prosper. Given our isolated geographic location, lack of resources and rapidly rising wage rates, Fomento's principal promotional tool is the ability of the Commonwealth of Puerto Rico to offer tax exemption from both Federal and Commonwealth taxes for fixed periods specified by law.[1] The effectiveness of this tool will be greatly enhanced by the provisions of proposed Section 936 to allow a dividends received deduction for dividends from a "possessions corporation" to its parent corporation, and to tax currently income from sources outside Puerto Rico.

As of December 1975, Fomento promoted factories provided 111,200 or 81 percent of the 136,500 jobs in all manufacturing. Non-promoted plants accounted for only 25,300 jobs. Employment in this latter group has declined slowly for many years, so that Fomento must create all of the net increase of 59,000 manufacturing jobs which our economy will require by 1980, just to reach 12% unemployment.

Puerto Rico's manufacturing sector is comprised of some 2,700 census establishments of which more than 1,400 are Fomento promoted. In this latter group there are some 900 establishments of United States and foreign origin and about 500 of local ownership. However, establishments of mainland ownership account for 85 percent of the employment in promoted plants. A majority of the mainland establishments are known to be owned by corporations organized under existing Section 931 of the Internal Revenue Code, and which would be covered by the proposed Section 936. Thus our ability to attract and keep "931 corporations" has been the core of our industrial development program. Because of the role of manufacturing in our economy, it has also been a key factor in the preservation and growth of our economy. We may expect (and badly need) even more significant results from proposed Section 936.

The mutually reinforcing incentives provided by Federal and Puerto Rican tax laws have not only given an enormous push to the Island's development, but have been highly beneficial to both the United States and even to the U.S. Treasury.

In fiscal year 1975, Puerto Rico was (with Brazil and France) the sixth best customer of the Mainland. That year, it bought $3.0 billion from United States, surpassed only by Canada ($21.1 billion), Japan ($10.3 billion), Mexico ($5.1 billion), West Germany ($5.0 billion), and the United Kingdom ($4.8 billion).

As to the impact of these purchases on the United States economy, a recent report indicates the following, with respect to calendar year 1974;[2]

(a) Nearly $2.7 billion of merchandise was shipped from the United States mainland to Puerto Rico. All 50 states and the District of Columbia participated in the benefits from these shipments.

(b) These shipments generated 139,000 jobs in the States, including 63,000 in forms producing final products or providing overland transportation, and 76,000 jobs in establishments supplying the first group. This employment does not include multiplier effects of jobs generated in the rest of the United States economy or jobs created in ocean transportation.

(c) These employment benefits were increasing at a rate of 7 percent per year, which would put them at 149,000 in calendar 1975.

(d) The Midwest, the North Atlantic States and the Southeast accounted for about two thirds of the employment benefits.

(e) Direct income benefits to United States residents were $2.5 billion and growing at a faster rate than employment benefits. (No calculation was made of tax revenues generated for the Federal Government but obviously they would be substantial).

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[1] Tax exemption is granted by the Governor of Puerto Rico in accordance with provisions of the Industrial Incentives Act of 1963, as amended, after consultation with Fomento and other Commonwealth agencies.

[2] Puerto Rico's Purchases from the United States 1974. Economic Associates, Inc. Washington, D.C., March 1975.

Furthermore, it is illusory to think that without the provisions of the Internal Revenue Code relating to Puerto Rico, the U.S. Treasury would obtain increased revenues. Most of the factories established in Puerto Rico under the present Section 931 would not exist or would be located in foreign countries. In any case, Puerto Rico's corporate tax rate is similar to that of the Federal Government; so imposition of Federal taxes would be washed out by a credit for Puerto Rican taxes. According to the Ways and Means Committee report, approval of Section 936 will actually produce a slight increase in Federal Revenues (page 259).

Last but not least, every American citizen, including Puerto Ricans, who works at a decent paying job is one that is not on welfare.

OUR DETERIORATING COMPETITIVE SITUATION

While manufacturing must carry an ever increasing load in our economy, the competitive situation of many of our important industries have been deteriorating, both with respect to the United States mainland and to foreign countries. This is another reason why, despite the success of Section 931, we need the boost of Section 936.

For many manufacturing operations, all important costs except labor and property taxes are equal to, or higher than, those on the mainland. For example, because 99% of our total consumption of energy depends on petroleum imported from foreign countries, electricity costs in Puerto Rico are higher today for industrial users than the average costs prevailing in any region on the mainland, for nearly all levels of demands.

For the same reason, our traditional advantage of $1.00 to $1.50 a barrel of crude oil has become a $3.00 to $4.00 disadvantage, even before approval of price controls on new domestic oil. Foreign naphtha, the chief raw material of our petrochemical industry and once a major incentive to its establishment, has risen in price from 5.5 cents per gallon to over 33 cents per gallon. By contrast, much of the domestic petrochemical industry operates on price controlled natural gas. As a result, our local industry is running way below capacity.

We also note that many manufacturing plants located in Puerto Rico must import their raw materials and ship out their finished products. Under the Jones Act, shipments between Puerto Rico and the U.S. mainland must be made in U.S. flag vessels. Thus Puerto Rico, together with Aslaska and Hawaii, bear the brunt of subsidizing the U.S. merchant marine. In the last few years, successive freight rate increases have totalled 62%.

However, the most significant factor in our deteriorating competitive situation has been the rapid increase in labor costs. During the period 1954 to 1972, value added per dollar of payroll increased in all major industry groups on the United States mainland. However, in Puerto Rico it declined in eight major groups (including apparel and textiles) which together still account for about 40% of total employment in manufacturing. Apparel alone provides 26%. Due in part to the application of the Fair Labor Standards Act to Puerto Rico, the average hourly earnings of production workers in Puerto Rico's manufacturing sector have increased faster than those in the States almost every year for the last generation.

As a result, Puerto Rico's lower wage industries have suffered a severe loss of comparative advantage in the United States market. Their loss has been even greater with respect to foreign countries, where minimum wages are much lower, unenforced or non-existent. By contrast, in Puerto Rico minimum wages are being phased in to mainland levels, by annual increases until they reach the mainland standard of $2.30 per hour for non-agricultural industries.

As the following tables show, Puerto Rico's market share of United States apparel imports declined from 37% to 16% in 13 years. Most of this decline has taken place since 1968 while United States apparel imports have increased by over a billion dollars.

U.S. APPAREL IMPORTS

[Dollar amounts in millions]

Exporting areas	1961 Amount	1961 Percent	1968 Amount	1968 Percent	1974 Amount	1974 Percent
Hong Kong, Korea	$46	12	$313	25	$1,160	51
Puerto Rico	141	37	370	30	363	16
Other countries	191	51	543	45	776	33
Total	378	100	1,226	100	2,299	100

As a result, despite growth in the total United States apparel market, employment in Puerto Rico's apparel industry in calendar year 1974 was barely above the level of 1969. In lower wage, labor intensive industries, both Puerto Rico and the United States have lost comparative advantage. However, for Puerto Rico this loss has been much more costly, because such industries provide a much larger part of its total employment, and a much more rapid growth of employment is necessary on the Island.

Thus, we have a mutual problem, foreign competition. The job that is wiped out by a poorly timed or excessive minimum wage increase in Puerto Rico will not return to the States. It will go to a foreign country or simply disappear.

The problem of foreign competition has been further intensified for both Puerto Rico and the United States as a whole by the recent implementation of the generalized system of preferences under the Trade Act of 1974. Various products of the chemical, food, electrical and leather industries now produced in Puerto Rico, or which we hope to produce, have been included in the list of duty free items.

We are attempting to keep these industries through increased productivity and the production of other raw materials in Puerto Rico while we gradually develop high productivity and high technology industries. Our principal tools in this effort are the tax exemption provisions in our own laws and in the United States Internal Revenue Code.

CONCLUSIONS

The foregoing indicates without a doubt that Puerto Rico cannot subsist economically unless the favorable interplay of Federal and Puerto Rican tax provisions continues and is improved. This is crucial not only to the maintenance of the present level of economic well being, but is absolutely essential to the continued development of the Puerto Rican economy. It is also highly beneficial to the economy of the U.S. mainland and even to the U.S. Treasury.

Without the interplay there would be, in the short run, a mass exodus of capital from Puerto Rico and, in the long run, a very low level of external direct investment in Puerto Rico, coupled with a substantial and continuous out-migration.

Moreover, the improvement of this relationship through the adoption of the proposed Section 936 (Section 1051 of H.R. 10612) is vital to our future progress, to make up the ground lost by Puerto Rico by inflation and recession, the deterioration of our competitive position and the difficulties which manufacturing enterprises face in obtaining external financing. Unless these recommendations are enacted into law we probably cannot get our unemployment back to 12% by 1980 or even by 1985.

In the world of today, no economy remains static for very long, least of all one such as Puerto Rico's, which is faced with rapid population growth and lack of natural advantages. It either goes forward or backward. In our case, backward means into economic misery, mass migration and social disorder.

The Government of the Commonwealth of Puerto Rico strongly endorses Section 1051 of H.R. 10612 to continue and enhance the present policy of the U.S. Government to encourage investment in Puerto Rico, and urges that these recommendations be speedily enacted into law.

THE IMPORTANCE OF MAINTAINING THE EFFECTIVENESS OF THE PUERTO RICO INDUSTRIAL DEVELOPMENT PROGRAM

Numerous U.S. enterprises and individuals have been attracted to Puerto Rico to set up manufacturing plants there, as the result of incentives offered under the Industrial Development Program. The principal incentives offered have been exemption from Puerto Rico Income Tax for a specified number of years depending upon the location of the plant. The effectiveness of this incentive has depended principally upon the fact that Puerto Rico organized corporations are not subject to U.S. Income Tax on income derived from sources in Puerto Rico, and U.S. domestic corporations operating in conformity with the provisions of Section 931 of the U.S. I.R.C. and its predecessor, Section 251 of the 1939 Code, are also not subject to U.S. tax on income from sources in Puerto Rico. A grant of tax exemption from Puerto Rico taxes is of trivial significance without a corresponding exclusion from U.S. taxation. The enactment of the proposed Section 936 to replace the current I.R.C. Section 931 would enable continuance of the Puerto Rico Industrialization Program.

In the 25 years since 1948, as a result of its industrial development program, Puerto Rico has made substantial strides in converting its economy from one which was largely agricultural, with a low per-capita income, to a more industrialized economy with a per-capita income which, while lower than that of any State of the Union, is higher than that of the respective Latin American countries. However, even with this substantial measure of progress, there is still an unemployment rate in excess of 12% in Puerto Rico. This is a factor which has contributed to the extensive migration of Puerto Ricans to various localities on the Mainland of the United States, particularly eastern seaboard cities.

The difficulties which Puerto Rico has confronted in its efforts to industrialize and create jobs must be recognized. Puerto Rico is an island located 900 miles from Miami and 1300 miles from New York. Except for the coastal area, its terrain is principally hilly or mountainous. It does not possess any extensive store of natural resources. To the extent that it possesses mineral resources, it will require massive investment and a number of years of development before they can contribute materially to the economy of Puerto Rico. Its principal natural resource is a mild and semi-tropical climate. Industries established in Puerto Rico are confronted with the necessity of having raw materials shipped in from the Mainland and of having the finished product shipped back to the Mainland or foreign countries. Thus, distance from potential sources of raw materials and markets for finished products inevitably increase the cost of production. The tax exemption incentive offered under the Industrialization Program has been a principal factor in inducing Mainland industries to establish plants in Puerto Rico. It should be noted that, throughout its Industrial Development Program, Puerto Rico has consistently pursued a policy of barring from the benefits of tax exemption, "runaway industries", that is, industries which close their plants in the States to avail themselves of benefits in Puerto Rico.

It may be noted that prior to the Industrialization Program in 1948, the Government of Puerto Rico made its own efforts to promote industrialization by establishment of industries financed by the government. Under this program, there were established a cement plant, a glass plant, a paper board plant and a shoe plant, among others. However, the limitations of this type of industrial development effort were early recognized, particularly with respect to products such as shoes. It became evident that any one plant producing given styles and sizes of shoes would be competing with a large variety of styles from Mainland and foreign sources and the possible percentage of the market for any one local Puerto Rico shoe plant would be negligible, so that its prospects of survival were problematical. It was thus recognized that the problem of marketing could not be solved except by those who already had the know-how and access to the market. In like fashion, it was learned that the acquisition of manufacturing know-how was a very expensive matter, in absence of management which already had experience in the field. It was in the light of recognition of such factors that the Government of Puerto Rico determined that the most fruitful means of industrialization was to offer incentives to induce those who already had the manufacturing and marketing know-how and capital to establish plants in Puerto Rico.

The industrialization program has yielded fruitful results in creating jobs, skills and a reservoir of technical and managerial personnel. However, it has been beset with major problems.

One of the major problems now faced by the economy of Puerto Rico, is the escalation of wages, particularly in the labor intensive industries. In the face of increasing wage rates, these industries which have been the backbone of the Industrialization Program up to the present, are particularly vulnerable, at this time, to the competition of a lower wage areas in other parts of the world. Thus, the Caribbean countries, such as Haiti and Santo Domingo, Central American countries such as Costa Rica, and South American countries, have been emerging as strong competitors in such fields as needlework. Realistically, it must be recognized that the obligations of the United States to these countries to foster their development will make remote the possibility of tariff or quota limitations on the output by these countries.

Another source of serious problems for the economy of Puerto Rico has been the precipitate rise in the price of crude oil joined with weakening demand and falling prices for certain petrochemical derivatives produced in Puerto Rico. As the result of this situation, the pioneer petrochemical complex in Puerto Rico, Commonwealth Oil Refining Company, has suffered massive losses in the past year, the other refineries have suffered losses, and Fibers International, a Phil-

lips Petroleum affiliate, dedicated to the manufacture of polyester staple from petrochemical intermediate products, has ceased operations.

The uncertain state of the economy, combined with wage increases and the oil crisis, has severely affected the economy of Puerto Rico. Numerous plant closings have taken place during the past two years. The construction industry is in a state of crisis. The current unemployment rate is over double the Mainland unemployment rate. In the context of these problems, the Industrial Incentives Program becomes of increased importance for the creation of jobs.

The fact that Puerto Rico is an island out in the Atlantic Ocean, with a population density which is one of the highest in the world (about 660 to the sq. mile, comparable to that of the Netherlands), must not be lost sight of. It would be a mistake to draw any parallels between Puerto Rico and the Virgin Islands or Hawaii, to both of which Section 936 would not be applicable. In the Virgin Islands, we are dealing with a population of 80,000 persons, in contrast with a population of nearly 3,000,000 in Puerto Rico. The tourist industry is the principal industry in the Islands and represents a vastly larger proportion of the gross income of these Islands than that industry represents for Puerto Rico. In the case of Hawaii, two major factors have served to differentiate it from the situation of Puerto Rico over the years. The first one is that direct federal expenditure, principally with respect to military and naval installations and personnel, is a much larger percentage of the gross income of Hawaii than such expenditures represent for Puerto Rico. The second is that Hawaii, with large areas of flat land has a more highly mechanized and developed agriculture than Puerto Rico. Accordingly, Puerto Rico must be dealt with on a different basis from these Islands.

Puerto Rico's isolated situation has the effect of depriving its economy of the resilience which the Mainland economy enjoys as a result of size and highly complex geographical and industrial interrelations. To the limited extent that Puerto Rico had been able to achieve some integration of industry, a measure of resilience has resulted. This is demonstrated in the needlework and knitwear industries. In the last 5 years, there has occurred in the Mainland apparel market, major changes in female styles. The popularity of "hot pants" resulted in a growth of the pantyhose industry and a decline in such industries as conventional hosiery and slips. The popularity of the pantsuits has had similar effect. A segment of the female population no longer regards the brassiere as an article of attire. All of these changes have had effects on employment and production in Puerto Rico. Thus, cutbacks and loss of jobs in the brassiere and slip industries among others, resulted. However, because of the presence of a trained needlework labor pool, industries devoted to the products of rising popularity, such as hot pants, pantsuits and other items of ladies sportswear, came to take their place. But even this limited measure of "moving stability" may be imperiled if labor intensive industries, such as the needlework industry are redirected to other areas of the world by a radical change of their current tax status in Puerto Rico.

The social effects of an arrest of the Industrial Development Program of Puerto Rico must be given consideration. At the present time, there is already evident a reverse migration of Puerto Ricans who have acquired skills in the States and who desire to return to Puerto Rico because of reasons of climate or family. To the extent that industrial development in Puerto Rico continues, the migration of unskilled persons from Puerto Rico to the Mainland cities will be arrested and the reverse migration from the Mainland encouraged. A curtailment of industrialization in Puerto Rico can only have the effect of accelerating migration from the Island to the Mainland. To the extent that the problems of Puerto Ricans can be solved in Puerto Rico, this will decrease pressures on the resources of the Major Mainland cities and the Federal government. In absence of incentives for operating in Puerto Rico, the capacity of some mainland industries with subsidiary operations in Puerto Rico to meet foreign competition would be substantially impaired.

Senator TALMADGE. Our next witness is Jules W. Burbach, president, Midwest Task Force for Beef Exports, Inc., and I believe he is Speaker of the House of the Nebraska State Legislature and the Chair recognizes the Senator from Nebraska.

Senator CURTIS. Thank you, Mr. Chairman. Senator Burbach will present the main testimony. He is accompanied by a distinguished group of panelists. Senator Burbach is one of the most able and

eminent leaders in our State legislature and with him today is Senator Carsten. We welcome you here.

I would like to have the various members of the panel identify themselves and whom they represent. Mr. McDermott, would you perform that service?

Mr. McDERMOTT. I am Frank McDermott. I am a Washington, D.C., attorney and am special counsel to Senator Burbach for his appearance today as well as tax legislative counsel for Iowa Beef Processors.

Mr. TITUS. I am Douglas Titus, an attorney with Iowa Beef Processors in Dakota City, Nebr.

Senator CARSTEN. I am Senator Calvin Carsten, chairman of the Revenue Committee of the Nebraska Legislature and a member of the Midwest Task Force for Beef Exports.

Senator CURTIS. Senator Burbach, how long have you been in the legislature?

Senator BURBACH. I am concluding 20 years.

Senator CURTIS. What is your business outside?

Senator BURBACH. Grain feed, sod, and fertilizer.

Senator CURTIS. So you are very much involved in agriculture.

Senator BURBACH. That is right.

Senator CURTIS. You come from a section of Nebraska where we produce and feed a lot of beef.

Senator BURBACH. Yes, we have a large feeding area.

Senator CURTIS. Your entire statement will be placed in the record and you may proceed in your own way.

STATEMENT OF HON. JULES W. BURBACH, A STATE SENATOR FROM THE STATE OF NEBRASKA, ACCOMPANIED BY HON. CALVIN F. CARSTEN, CHAIRMAN OF THE REVENUE COMMITTEE, DOUGLAS TITUS, AN ATTORNEY WITH IOWA BEEF PROCESSORS, INC., FRANCIS O. McDERMOTT, A PARTNER IN THE CHICAGO LAW FIRM OF HOPKINS, SUTTER, MULROY, DAVIS & CROMARTIE

Senator BURBACH. Mr. Chairman and distinguished members of this committee, it gives me a great deal of pleasure to appear this morning to discuss this very important subject affecting the Domestic International Sales Corporation, generally referred to as DISC.

The bill, H.R. 10612, which the Finance Committee is considering today is characterized as one designed to "improve substantially the equity of the income tax at all income levels." To achieve this worthwhile aim, it has not only cut down on the stimulus provided by the DISC program, but terminates any further benefit to the agricultural community, particularly to the beef industry.

It is hard and difficult for me to understand as a legislator how equity is met through such discriminatory hard-handed action.

Originally DISC was designed to provide a significant incentive to expand exports and place U.S. domestic firms on an equal and competitive tax footing with foreign subsidiaries of U.S. corporations. This equality was achieved by enabling qualifying domestic corporations to defer tax payments on approximately 50 percent of their export income from sales and related activities. Export expansion for both agriculture and industry is not only desirable but necessary be-

cause of its favorable effect both on our balance of payments and the value of our currency and on domestic employment.

The continued development of new markets for agricultural products not only benefits farmers and feeders but others—employers and employees in transportation, stores, handling facilities, et cetera. Some of these good people may unwittingly complain that exports increase domestic food prices, and at the same time, owe their livelihood to the very products exported.

The beef industry presents a very good example of price mechanism. Because of a credit system, exports should not result in an increase in price. The reason is quite simple. The farmer who feeds cattle and sells to the producer or processor receives a credit for those parts of the animal which are exported abroad such as the hide, tallow, and protein—the byproducts of the beef animal. The higher the price obtained from these export products, the greater the benefit to the feeder. Simply stated, the greater the credit, the higher price the packer pays to the farmer for his cattle.

A similar benefit occurs on the consumer side where a higher marketing credit results in lower price for fresh beef to the housewife. This occurs since the export items such as skirt steaks, kidneys, and so-called hanging tender items, not generally consumed in the domestic market are exported. This export reduces the total cost of consumer beef, as a credit to the wholesaler. The greater the export price, the lesser the price to the American consumer.

Price competition is a major determining factor in the international movement of bulk agricultural products. Maximum production allows economies of scale which means lower prices due to lower costs of production. Our farmers can produce quantities commensurate with their decisions concerning the size of the market. Existence of DISC assures the farmer that the U.S. Government is committed to maximizing exports and thus influences their decisions. The proposed discriminatory treatment of the House bill will undermine this commitment and break faith with the American farmer and feeder.

Export assistance is especially important to the medium and small sized U.S. firms and cooperatives. Many of these producers and processors are competing with a sizeable number of third country competitors, which, in turn, receive export subsidies and other assistance from their respective governments. Agricultural firms, basically producers and processors, benefiting from DISC include those handling grains, livestock, livestock products, dairy, dairy products, poultry products, seeds, tobacco, cotton, agricultural chemicals and other commodities. It is interesting that the discrimination in the House measure does not fall on a few agricultural commodities. These are tobacco, peanuts, so-called extra long staple cotton, and, perhaps, rice if marketing quotas again apply to it. The justification for this carveout is their asserted excess supply. While I applaud their continued aid, I question the logic of excluding all other agricultural products, especially beef.

An important question is what is the magnitude of the participation of agriculture in the DISC program. The latest statistics that I have available from the Treasury Department and the public hearing record of the Ways and Means Committee of the House reflect that approximately 18 percent of the DISC exports were agricultural products. This means of the total exports attributable to DISC in 1972,

nearly $50 billion, approximately $9 billion came from agricultural export products. It is estimated that about 6.1 percent of the revenue impact of DISC is attributable to agriculture. Using the projected 1975 costs of the House report of $1.3 billion, agriculture has only an $80 million impact. Viewing the denial of agricultural products from any further DISC benefits in this light demonstrates that the termination of benefits to our industry is similar to chopping a goldenrod in a forest of trees.

In conclusion, Mr. Chairman, the United States is highly dependent upon the export of agricultural commodities. American agricultural products have encountered many different types of tariff and nontariff barriers around the world. DISC, while not eliminating these barriers, has at least allowed exporters of agricultural products a reasonable chance of counterbalancing these barriers.

A favorable balance of payments is crucial to this Nation's economy. Without a favorable balance, the value of the dollar declines internationally and inflation's fires are fanned. In recent years, agriculture has contributed greatly to the balance of payments—without the excess of agriculture exports over agriculture imports, this Nation would now be in trouble.

We, therefore, respectfully request this committee to reject the proposed cutback in DISC benefits, particularly the elimination of agricultural products from future DISC treatment. We urge retention of the present DISC program and its strengthening—not its diminution.

Senator CURTIS. Thank you for a very splendid statement.

What does the State of Nebraska expect to gain from DISC?

Senator BURBACH. Nebraska is primarily an agricultural State. Its exports account for 22.3 percent of the total U.S. value of agricultural commodities for exports. DISC is an integral part of that program.

Senator CURTIS. How about the Midwest Task Force for Beef Exports, which is a nonprofit organization. What benefits do they expect to receive if DISC is retained?

Senator CARSTEN. Senator Curtis, the task force as such will gain no financial benefit. The only benefit the task force will receive will be the benefits to the exports of beef. This is the principal reason for our incorporation is to increase the beef exports.

Senator CURTIS. If we export meat as well as grain, will there be more jobs available in this country?

Senator BURBACH. Senator Curtis, I think it is extremely important that we export not only our feed grains but more importantly step up our beef because we in Nebraska and the United States, through employment using all of our feeds and feed grains exporting the finished product rather than raw products.

Senator CURTIS. What livestock products are available for export?

Senator BURBACH. Nebraska, for example, ranks third in the Nation in the export of hides and tallow; fourth in exports of meat, meat products, not including poultry, and exports of sizable tonnages of dairy products.

Senator CURTIS. And a great potential market exists for other products too, isn't that true?

Senator BURBACH. Yes.

Senator CURTIS. We have such a growing number of first-class hotels and restaurants all around the world. While some population groups

are not in a position to buy our best grades of meat, all of those hotels and restaurants in every country of the world, including some of the less-developed ones, are potential markets for the fine beef we produce here. Is that not correct?

Senator BURBACH. Yes, for example, it was recently brought to my attention that the number of visitors to Spain—tourists—are greater than the number of people living in the country. Thus, Americans and other travelers prefer their own country's meat in those restaurants and hotels.

Senator CURTIS. Does the domestic meat production lend itself to export markets?

Senator BURBACH. Our domestic production does lend itself to export markets, especially to the tourist trade previously mentioned. Last year the United States exported approximately $1.5 billion in live animals, meat and meat products. The foreign market is basically a specialized market, requiring specialized cuts and limited supplies. The U.S. meat industry has a valuable chance to develop the export market potential consistent with any incentive available to do so.

Senator CURTIS. Have the export markets been successfully developed?

Senator BURBACH. Restrictive foreign quotas, varying inspection and sanitation standards, tariffs and trade barriers and Government protocol have limited development of foreign meat markets. On the other hand, successful export markets have been created for various grains, soybeans and other agricultural products. To deny DISC benefits now to meat and beef products would be particularly harmful because of these restrictive foreign practices.

Senator CURTIS. I was impressed in your statement of the effect of exports on the consumer. Will agricultural exports give rise to higher domestic prices on agricultural products to the U.S. consumer?

Senator BURBACH. In answer, Senator Curtis, the following points are valid. Again, the ability of the U.S. farmer to utilize resources and technology for agricultural production is unparalleled throughout the world. Its continued involvement in production is dependent on a reasonable return on land, labor management and capital. Thus, to minimize market fluctuations and give more stability to prices received for agricultural products, export markets will benefit not only the farmer but the U.S. consumer. Export markets, at this point, provide financial incentive from a tax standpoint and may provide less fluctuation in market prices because of a more uniform supply of any product at any given time resulting in more reasonable prices.

Also, as I indicated before, there are certain cuts of beef, which are part of the cost of beef, we do not eat here in America. But many of these cuts are very palatable and very much in demand in the foreign countries. This export results in a dual saving—to the Domestic beef producer and to the American housewife.

Senator CURTIS. Mr. Titus, I have a question for you. Do you believe that DISC helps the farmer-feeder and beef consumer here in the United States?

Mr. TITUS. Yes, Senator Curtis. I would like to elaborate on some of the points that Senator Burbach has just made. If we are able to get higher prices for some of the products the Senator has mentioned, such as hides, tallow and proteins exported abroad, the pro-

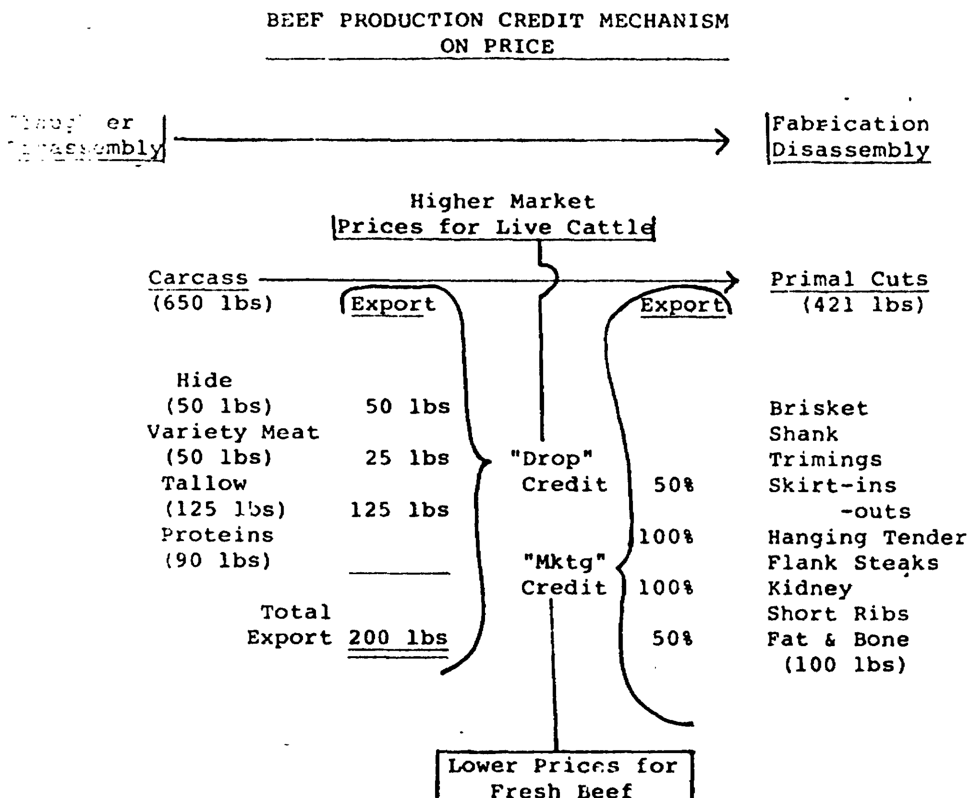
ducer is able to give the feeder and grower a credit. The higher price that is received from the sale of products abroad, the higher the credit, and this credit is directly passed on to the feeder. There are two examples that I know of with our company. Recently, we were able to develop a higher export price for hides and the benefit from that price was passed directly on to the feeder as a savings through this credit system. Second, in the last year and a half we developed a better market for tallow in Mexico, and the higher prices generated for tallow were passed directly on to the feeder.

Now, of equal importance is the fact that after the packer-processor breaks a carcass and cuts it to primal and subprimal cuts there are numerous cuts that are not desirable nor marketable in this country. These are cuts such as hanging tenders, flank steaks, short ribs, livers, and similar items. If we are able to develop a foreign market for these, with a higher price in Europe and in other parts of the world, we will be able to charge a lower price for the primal and subprimal cuts that are in demand in this country. Thus passing reduced costs with lower prices directly to the wholesaler and hopefully directly to the consumer.

Mr. Chairman, I have a chart with me that explains both the drop credit at the packer-slaughter level and the credit for these various products at the wholesaler-consumer level, and I would like to have it inserted in the record.

Senator TALMADGE. Without objection it will be inserted in the record at this point.

[The chart follows:]



Senator HANSEN. Do you feel the House passed provisions fairly treats beef producers?

Mr. TITUS. Senator Hansen, I believe it is totally the opposite. This morning, Representative Karth mentioned that the House bill dealt only with agricultural commodities. The DISC changes in the House bill not only single out agricultural commodities but agricultural producers and applies as well to the feeder, the grower, and the packer-producer alike.

The DISC provisions of the House bill completely discriminate against the farmer in favor of the manufacturer.

I do not understand why agriculture in general, and beef producers, in particular, have been singled out for discriminatory treatment. All we ask is equal treatment, as a producer, with the manufacturer. Obviously, this unequal treatment cannot logically be defended.

Senator HANSEN. Are there any other benefits you might see in this legislation?

Mr. TITUS. I think one of the greatest benefits is one for which the legislation was initially adopted in 1971, namely the expenditure of capital domestically. We, for example, are using our producers' loan money under the DISC program for development of plant and equipment to produce products for export. We are now planning a facility for the export of tallow directly. Second, a very visual benefit that has been generated within our company is the use of domestic U.S. flagships. Previously we usually used foreign vessels not only because they were cheaper but because they were more available. Now we have made a conscious effort to ship all of your products on U.S.-flag ships.

Senator HANSEN. In the interest of time, I will forego any further questions.

Senator TALMADGE. Senator Byrd.

Senator BYRD. I have no questions. I might make one comment to this delegation from Nebraska. Your State has outstanding representation in the U.S. Congress and outstanding representation on this committee. Thank you for appearing here.

Senator BURBACH. Thank you. We wholeheartedly agree.

Mr. Chairman, could Mr. Titus' statement be inserted in the record?

Senator TALMADGE. His full statement may be inserted in the record.

Senator PACKWOOD. Senator Burbach, explain to me how these certain commodities, tobacco, peanuts, long staple cotton, and perhaps rice are exempt from the DISC provisions of the House bill.

Senator BURBACH. I will defer to Mr. McDermott.

Mr. MCDERMOTT. Senator Packwood, your question goes to the heart of the matter and is precisely why we feel the House bill, and we are now joined by Congressman Karth who put together the House compromise and just testified is not appropriate in excluding agricultural commodities.

However, Congressman Karth did not comment on the real basis that agricultural products are hit with discriminatory treatment. The conceptual approach, according to the House reasoning, was that, if you have an excess supply of different types of agricultural products, such products will not be in short supply on the domestic market. If they are not in short supply, their export to other countries will not affect the domestic price to the consumer; namely, the housewife.

In applying this test the Ways and Means Committee had to find a governmental or some other type of determination to have the exclusions work.

Senator PACKWOOD. Wait a minute. You lost me there. To have which exclusions work?

Mr. McDERMOTT. The exclusion of the four agricultural products.

Senator PACKWOOD. And you say they are not in surplus?

Mr. McDERMOTT. That is correct.

To achieve this aim the committee bill has just a brief citation in its technical language incorporating the Agricultural Adjustment Act of 1938, and its marketing quota program to be used to determine crops in excess supply. That brief citation incorporates about 150 pages of the Agricultural Adjustment Act which is really difficult to understand, particularly for a tax lawyer.

Senator PACKWOOD. Are those things that are going to be found in short supply those things produced by marketing quotas?

Mr. McDERMOTT. That is correct.

Senator PACKWOOD. Anything under a marketing quota, per se, will be in short supply.

Mr. McDERMOTT. No; in excess supply.

Senator PACKWOOD. If they are under a marketing quota?

Mr. McDERMOTT. Yes.

Senator PACKWOOD. And therefore subject to the full provision.

Mr. McDERMOTT. Yes. There are four such commodities mentioned in the House report subject to marketing quotas under the act except rice which has not been under it since 1973. However, eligibility can be regained. To come under the marketing quota, almost all farmers in that production have to agree to that quota.

In the beef industry we don't expect that type of cooperation.

Senator PACKWOOD. How, in any stretch of the imagination, could beef be found in short supply.

Mr. McDERMOTT. It should not be. Why it is not under the Marketing Act, I don't know.

Senator PACKWOOD. It seems to me the DISC provisions would be applied to the sale of wheat absent the most extraordinary crop failure in the country for the foreseeable future because we will grow twice over what we use.

Mr. McDERMOTT. Wheat, at the present time, is not so qualified. It would have to go through an extremely difficult equalification route to once again be eligible under the marketing quota system.

Senator PACKWOOD. You are putting it in the reverse, if you are not subject to a marketing quota you will be found to be in short supply; is that correct?

Mr. McDERMOTT. That is correct, and, to employ marketing quotas against beef products in excess supply is inappropriate and not equitable.

Senator PACKWOOD. I can justify the argument something in short supply we should not encourage export but to use the marketing quota as a standard as to whether you are in short supply is an unworkable, unreal standard.

Mr. McDERMOTT. I completely agree, Senator. That is why we feel Congressman Karth apparently concludes that is no longer an acceptable provision in the House bill and we agree wholeheartedly.

Senator PACKWOOD. I have read Mr. Titus' statement.

Senator TALMADGE. His statement will be inserted. Unfortunately all the time for the panel was utilized before we got to Mr. Titus but you may ask him some questions if you see fit.

Senator PACKWOOD. First, what is Iowa Beef Processors? Is it a stock company?

Mr. TITUS. Yes, and it is the world's largest processor and packer of beef products.

Senator PACKWOOD. Go to pages 6 and 7. Tell me first why your exports fell so dramatically in 1975.

Mr. TITUS. The exports generally fell dramatically in 1975 for the country I understand. Further, Iowa Beef pursuant to present DISC provisions is restructring its export departments and operations so we have had perhaps different people performing different functions in order to get under way for the coming year.

Senator PACKWOOD..On page 7, you indicated you are operating in the neighborhood of 1 percent margin for your domestic sales. Is this the same for export also?

Mr. TITUS. I am not sure what the margin is for export products. As I understand, dealing with our special and export products division, the margin on those products fluctuates drastically. Sometimes it is in excess of 1 percent.

Senator PACKWOOD. Let's assume 1 percent for a moment. Take me through this mathematically. In 1974 you have $56,500,000 in exports and you have a $565,000 profit. Assuming a 50-percent taxe rate and I realize that is high, without that you pay 50 percent in taxes.

Mr. TITUS. That is correct.

Senator PACKWOOD. With DISC you pay only half of $141,000 and you are going to defer the tax on the other $141,000 so you have $141,000 of working capital you would not otherwise have. You can defer tax on it for a susbtantial period of time. I have asked a number of other witnesses this question but I am not sure in your business it would be applicable. Would you be willing to rade off DISC, get rid of it, in exchange for a 2-percent change in the corporate tax deduction?

Mr. TITUS. Senator Packwood, I think you have hit the nail on the head. I don't think I can answer that question on behalf of Iowa Beef directly. As the legislation presently stands, we and the feeders and the growers have been effectively excluded from the DISC program. So, right now, we have no fingers in the pie whatsoever.

Senator PACKWOOD. What you are saying is that anything is better than what you have?

Mr. TITUS. Right. If agricultural and horticultural products were reinstated. I think we could state that the 2 percent tax reduction for the corporation would not directly stimulate the export markets the DISC is designed to stimulate.

However, the corporation would indeed welcome the 2 percent reduction.

Senator PACKWOOD. I think I understand your answer.

Thank you, Mr. Chairman.

Senator TALMADGE. Gentlemen, you have made a very impressive presentation. It does seem to me discriminatory to exclude agricultural products. Agriculture is the one bright sign in our export trade at the present time. Last year, as I recall, we exported about $22 bil-

lion worth of agricultural commodities. We imported about $10 billion of agricultural products which gave us a net on agricultural trade of about $10 billion or approximately half what it cost us to import OPEC energy.

I have only one question of Senator Burbach. Do you have a unicameral legislature in Nebraska——

Senator BURBACH. That is right.

Senator TALMADGE. Are all members called Senators?

Senator BURBACH. That is right. Evidently, we are a bit more proud of that designation. We see your nameplate is titled as "Mr. Talmadge." If we had those nameplates it would be "Senator Talmadge" and "Senator Curtis."

Senator CURTIS. I think we should have the record show every member of the Nebraska Navy is an admiral, too.

Senator TALMADGE. Thank you very much.

[The prepared statement of Mr. Titus follows:]

TESTIMONY OF D. DOUGLAS TITUS, ESQ. ON BEHALF OF IOWA BEEF PROCESSORS, INC.

Mr. Chairman and distinguished members of this committee: I am pleased to be here this morning accompanying Senator Julius Burbach, speaker of the Nebraska Legislature, and to present comments on the important subject of DISC.

My name is Douglas Titus. I am staff attorney for Iowa Beef Processors, which is located in Dakota City, Nebr. I am accompanied by Francis O. McDermott, a partner in the Chicago law firm of Hopkins, Sutter, Mulroy, Davis & Cromartie.

In order for the committee to fully appreciate the adverse impact that the DISC provisions of the House bill will have upon our operations, it would be worthwhile for the members to be acquainted with our background and operation, particularly in the export field.

BACKGROUND AND OPERATIONS OF IOWA BEEF PROCESSORS

Iowa Beef Processors, Inc. ("IBP") is the world's largest producer and processor of carcass beef, beef products, and beef byproducts. IBP, began its operations just 15 years ago in 1961 with one packing house located in Denison, Iowa. It now has three large slaughter/processing facilities, five slaughter-only facilities and one custom products plant located in the States of Minnesota, Iowa, Nebraska, Kansas and Texas.

The corporation purchases its raw material and cattle in 17 States and distributes its products to wholesalers, retailers and the hotel, restaurant and institution trade throughout the United States. In addition, IBP's wholly-owned subsidiary, Denison Hide Company is the world's largest single producer of cured hides.

Since its inception, IBP's main thrust has been to bring efficiency to a traditionally inefficient industry and thus to produce beef products at lower costs while passing these cost savings on to the American consumer. This company has sought that goal through such innovative methods as locating its production facilities in the geographic areas where cattle are fed—substantially reducing the transportation costs for live cattle. In addition, the company designed and built complex, computer-mechanized beef fabrication facilities where the carcasses are broken down into primal and subprimal cuts for sale to IBP's customers. This fabrication produces substantial savings to the consumer in the elimination of transportation costs for unwanted portions of the carcass such as fat and bone.

These steps toward efficiency are not, however, without their own costs and capital commitments. Although packing houses alone have long been capital-intensive because of the many production steps necessary to dress cattle for sale, the final processing of the carcass into more useable portions requires tremendous amounts of capital in buildings and machinery. Consequently, where capital needs for purely domestic production, sales and distribution are so great, little importance was placed upon stretching the resources of the

corporation or the industry, for that matter, into facilities for sale and distribution of products outside the United States.

Aside from the financial requirements of heavily committing a beef producing corporation to foreign market penetration, another obstacle has existed. This hurdle to the free and profitable distribution of beef products outside the United States is the tariff and non-tariff barriers erected by foreign nations to the import of primary beef products; for example, such barriers are used extensively in European Economic Community nations. To further exacerbate the domestic beef producer's situation has been the unrestricted practice by foreign producers of dumping livestock and beef products in the United States, clearly giving such producers a subsidized competitive edge over the domestic beef industry.

It was in this difficult economic picture, obviously recognized by Congress for industry generally, that legislative action was necessary to provide proper help. This relief came in the form of the Domestic International Sales Corporation (DISC) provisions of the Revenue Act of 1971. It not only provided relief for the American producer from the above restraints, it also served to encourage promotion of otherwise closed foreign markets. Responding immediately, IBP formed a wholly-owned subsidiary, IBP International, Inc., which was qualified as a DISC in January of 1973. In reliance upon the DISC provisions, IBP, and Denison Hide Company, through contracts with IBP International, Inc., began a serious commitment to the development of an international market for these companies' products. In terms of product sales, these efforts have yielded the following results by product lines:

Inedible tallow.—160 million pounds per year produced/approximately 60% exported.

Tongues, Kidneys and Sweetbreads.—12 million pounds per year of tongues, 3 million pounds per year of kidneys and one half million pounds per year of sweetbreads produced/approximately 90%.

Hides.—3 million hides per year produced/approximately 30% exported.

Export sales receipts for IBP International for fiscal 1974 were approximately $56,000,000, a considerable increase in export sales over approximately $30,000,000 for fiscal 1973. As an additional example of the results of IBP's efforts, IBP's market share in France for liver sales increased 16% and its share for other offal products 15% over the same period.

The following chart illustrates, in approximate figures, the growth in IBP's export sales since the company's inception. The figures for the first ten years basically parallel the sales growth of this young company; however, total export sales dollars for the last three years since IBP has utilized a DISC have made a dramatic upsurge when compared with gross sales increases for the company as a whole. For example, during fiscal 1974, IBP's export sales increased 75% while total sales increased 8.1%. For the previous year (1973), export sales increased approximately 40% while total sales increased 14.3%.

IBP Export sales 1961–75*

Year:	
1975	$42,003,000
1974	56,503,000
1973	32,701,000
1972	23,263,000
1971	13,980,000
1970	9,827,000
1969	9,863,000
1968	7,075,000
1967	6,035,000
1966	5,722,000
1965	2,815,000
1964	2,676,000
1963	2,474,000
1962	1,152,000
1961	485,000

*While the company maintained total sales figures for years prior to establishment of the DISC, it did not break out export sales figures; consequently, the chart figures for 1961 through 1972 are approximations developed by the Controller's Division of IBP.

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In earlier years, as a matter of priorities, IBP did not wish to commit its resources to international markets because one of its clear goals was to "feed Americans first." Another reason, however, was that it was necessary to invest profits in domestic production facilities. Unlike other American industries, the meat industry's profit margins have been traditionally slim, in the neighborhood of 1% (for example, for IBP's fiscal 1974, on sales of $1,538,198,000, net revenues were $16,538,000). The new DISC statute has allowed IBP to change the above priorities somewhat because the tax deferral provisions provide additional funds for export expansion without sacrificing domestic capital needs.

As stimulated by the impetus given by the DISC provisions of the Internal Revenue Code, IBP has taken strong affirmative steps and begun export-related planning and development. IBP's export sales department was drastically overhauled and a new manager, with export experience, recruited to develop export markets for hides and beef products. Plans are currently contemplated, or in the course of actual production, to construct new facilities to produce, or enhance the distribution of export products.

In addition, IBP, through its DISC subsidiary, has embarked on several totally new courses of action as stimulated by the DISC provisions. First, IBP International has opened an European office to promote export sales abroad. Secondly, a department has been set up to promote the sales of boxed beef products in Europe and Japan, a market hitherto closed to IBP. The financial stimulus behind these affirmative steps to promote sales abroad has come from the retained earnings of the DISC which are available for financing of export product receivables and inventories as well as for use in construction of export related facilities. Whereas the company could not justify substantial outside borrowings for investment in domestic facilities and the additional overhead necessitated for export promotion expenses, the availability of funds from the DISC itself is an obvious stimulant to such investment and activity.

In promoting export sales, it has been IBP's goal to invest export-promotion capital for facilities and to make business expenditures domestically, whereby the benefits generated by the use of such funds will inure not only to the United States Treasury, but also to the many persons who are dependent upon this industry. The present DISC legislation promotes domestic use of DISC funds. Similarly, the DISC legislation has stimulated IBP to use U.S. flag vessels for the transportation of its products to foreign lands, although the availability of such vessels is often a problem. Promotion of the use of such vessels is generated through the DISC provision which allows a DISC's earnings to include 5% of shipping charges if export products are shipped on American flag vessels.

IBP's export sales of approximately $60 million for last year are not overwhelming in terms of the gross national product, however, such sales are still substantial when viewed in their proper perspective for a corporation with assets of approximately $200 million. IBP's increased export activity, predicated primarily upon the stimulus given by the DISC provisions, has, over the past three years, contributed to the nation's interest in its balance of payments, and will increasingly so contribute in the immediate future.

ADVERSE IMPACT OF SECTION 1101 OF H.R. 10612

The House bill restructures the availability of DISC benefits in such a way that it deprives IBP of any future help and adversely imposes recapture of previous tax benefits over a very limited time period.

H.R. 10612 proposes to cut back DISC benefits in two ways:

1. The bill strips certain industries, or portions thereof, from any further DISC benefits after October 2, 1975. Generally, it disqualifies agricultural products including beef exports (except agricultural products in excess supply), and military equipment from further DISC treatment after that date. (Those agricultural products held to be in excess supply must meet strict criteria and are presently confined to just rice, tobacco, peanuts and extra-long staple cotton.)

2. The House bill restricts benefits for companies with taxable income in excess of $100,000 to income on gross sales in excess of 75% of average sales during a so-called moving base period.

Even without additional analysis of the impact of the foregoing changes it is evident that the House bill tremendously complicates the DISC program and will result in eliminating much of the stimulus it has provided in the export field,

particularly with regard to beef products. Specifically the first change outlined above will terminate any further DISC benefits to Iowa Beef for its now established and very important export trade business. This is particularly hard on our company since the bill lacks any well-thought-out or well-developed transitional rules for companies such as ours exporting the now disqualified items.

Recognizing the need that something be done, the Ways and Means Committee adopted and the House bill contains a so-called "two for one" rule. This rule permits the proposed "disqualified DISCS" to recapture their DISC earnings over a period calculated on the basis of two years for every one year that the DISC was in existence (up to a maximum period of ten years) prior to the proposed termination in H.R. 10612. In other words, as in our case, if a company's DISC were in operation for three years it would be required to recapture its accumulated DISC earnings over a six-year period. This presumes that a short taxable year is treated as a full year for purposes of the "two for one" rule. If not, the impact tax-wise is even more drastic.

It is noteworthy this so-called termination relief was not even part of the original compromise version reached by the Ways and Means Committee in its consideration of DISC revision. That compromise contained no transitional provisions for the benefits terminating particularly in the agricultural area. The "two for one" rule was adopted just prior to the Ways and Means Committee ordering the bill reported favorably. I believe this is highly important because it demonstrates adequate consideration was not given to the adverse impact the termination will have on companies nor appropriate time given to consider alternatives rather than out and out termination.

RECOMMENDATIONS FOR THE COMMITTEE'S CONSIDERATION

First and foremost, IBP respectfully urges that the comments of the Honorable William E. Simon, Secretary of the Treasury, presented to this Committee on March 17, 1976, be strongly considered and that DISC benefits be retained under present law, and, further requests this Committee totally reject the House cut backs in the DISC program. Secretary Simon is correct when he observes in his testimony:

"DISC has been in place for only a short time. And, it is working. Many companies have made significant investments in reliance on it, but the legislative tinkering with the DISC can only weaken the program. DISC, like the investment credit, should not be turned on and off depending on the whim of the moment. We must resist the temptation to adopt stop and go policies, which create a climate of great uncertainty for business planning." (Page 91)

IBP is certainly an example where after only a short period of time DISC is indeed working and we have made significant investment in reliance on it. We cannot understand, nor should this Committee be ready to accept, this on-again off-again policy with regard to a tax incentive that works. Certainly the lesson learned from the investment credit should be sufficient to give caution to any quick termination of what was established as an on-going program.

Tax history reflects that the spigot treatment of a similar incentive, the investment credit, each time it was attempted resulted in economic perversity and in some capital intensive industries, a real economic hardship. The same parallel exists regarding the DISC program. Peculiarly, even the period of years that have elapsed between the initial start of the DISC program and its now recommended cut back to the start up of investment credit and its first suspension—5 years—suggests a cautious and deliberate consideration before acceptance of any suggestion along the lines of the House bill.

In the event that the Committee should decide that the proposed incremental approach contained in the House bill be adopted, we strongly recommend that such an approach, (which we feel is inappropriate and agree with Secretary Simon in this regard) be adopted across the board for all presently qualified export commodities. We do not feel that presently qualified DISCS, whether they be in the export of manufactured or agricultural goods should be treated differently. The basic thrust of the DISC legislation was to provide a stimulus for exports and create jobs here in the United States. It has done that, both in the agricultural area, particularly in our case of beef products, as well as in the

manufactured area. It has created not only the stimulus for export. but jobs for our employees. Admittedly, in so doing DISC has cost money, but every tax benefit does. We feel in this case that this tax benefit is fully justified and should be continued.

Also, we particularly are concerned with the elimination of tariff and non-tariff barriers to the free trade of high quality beef products throughout the world. Consequently, we hope the Committee will keep in mind the trade negotiations presently under way and that any change should only be made which results in effective international agreements with compensating actions by our foreign trading partner. Actually our DISC program provides much less benefit to U.S. exports than the practices that other countries afford to their exports. We should not therefore, hinder our negotiations or place our country in a lesser position by undermining existing programs such as DISC.

CONCLUSION

In conclusion, Mr. Chairman, the so-called Tax Reform Act of 1975 (H.R. 10612) is reportedly designed to achieve a four-fold objective:

1. To improve substantially the equity of the income tax at all income levels,
2. To simplify many tax provisions and delete unnecessary language,
3. To continue through the calendar year 1976 the economic stimulus provided earlier this year by the Tax Reduction Act of 1975, and
4. To make important improvements in the administration of the tax laws.

Upon analysis, the bill in terms of its discriminatory treatment of beef producers fails to achieve any of these worthwhile objectives. First, it achieves no equity with regard to a beef producer since it totally discriminates without justification against him. It does so by cutting off as of October 2, 1975, further DISC treatment for his export sales. The reasons set forth by the House Committee for eliminating agricultural goods and therefore beef products from DISC benefits was "that export incentives are not needed because of the high level of foreign demand for the products." This is certainly not the case for beef producers generally. The beef market abroad must be developed through efficient competition. The House proposal stifles needed funds to achieve such an objective.

Secondly, simplification is obviously not achieved by the many nuances created through the so-called "incremental approach" and new definitions needed to determine the base year periods.

The third objective, namely of continuing "economic stimulus" is obviously contradicted by taking away from a benefit specifically designed to provide economic stimulus.

The fourth objective "administration improvement in the tax laws" is not achieved where an already acknowledged complicated DISC program is engrafted with a proposal that this Committee thoroughly analyzed and rejected in 1971 when the original DISC legislation was before it. The present compromise reached by the Ways and Means Committee and accepted by the House differs very little from their original recommendation in 1971 when they first sent the DISC legislation for consideration by this Committee.

After due consideration, this Committee found the incremental approach to be highly complicated and unduly discriminatory, particularly against those companies having existing DISCS to those starting new DISCS. It rejected the House recommendation and developed the 50% exclusion rule which is present law.

We earnestly urge the members of this Committee once again to reject the House recommendations.

Senator TALMADGE. The next witness is Mr. David Garfield, special committee for U.S. exports, vice chairman of the Ingersoll-Rand Co., accompanied by Mr. Phil F. Sauereisen, president, Sauereisen Cement Co.; Peter Nelsen, president, Globus Corp.; and Robert G. Hyde, director, international programs, General Dynamics.

Your entire statement will be inserted in the record and you may proceed to summarize it, Mr. Garfield.

STATEMENT OF DAVID GARFIELD, CHAIRMAN, SPECIAL COMMITTEE FOR U.S. EXPORTS AND VICE CHAIRMAN, INGERSOLL-RAND CO., ACCOMPANIED BY PHIL F. SAUEREISEN, PRESIDENT, SAUEREISEN CEMENT CO.; PETER NELSEN, PRESIDENT, GLOBUS CORP.; AND ROBERT G. HYDE, DIRECTOR, INTERNATIONAL PROGRAMS, GENERAL DYNAMICS

Mr. GARFIELD. We have substituted Robert Ramsey of Bell Helicopter for Mr. Hyde.

Our committee represents over 400 leading American industrial companies as well as 40 business associations. Our objective, of course, is a continuation and enhancement of the concept of the Domestic International Sales Corp. The committee was started only a little less than 1 year ago and it has been extremely impressive to me that so many outstanding firms would give their support to our organization in such a brief period of time. We have prepared a considerable amount of written testimony which has been submitted for your information and for the record.

However, in the brief time available here, I would like to highlight some of the more important of our findings. By the way, these are generally in support of the comments made earlier by Congressman Karth, who I consider to be very well informed on this whole subject.

First, over 8,000 DISC elections have been made and in only a little over 4 years, the DISC concept is being widely supported from small- and medium-sized firms as well as the larger organizations. I understand that 50 percent of all U.S. exports in the fiscal year 1974 were DISC related. We have estimated $6 billion of current exports or approximately 5 percent of the total occurred because of DISC. Moreover, the Department of Commerce has estimated each $1 of exports generates a $3 addition to our gross national product. Thus, increasing exports have an unusually beneficial impact on the economy. Even if we evaluate only the Federal tax revenues derived from the DISC-induced exports themselves without considering the multiplier effect to the gross national product the extra Federal revenues are on the magnitude of $1.6 to $2.1 billion, which far exceeds the hypothetical revenue loss of $1.3 billion assigned to DISC for calendar 1975.

Above all, exports provide jobs. Treasury Secretary Simon has commented that as much as 10 percent of our domestic work force or about 8 million people are engaged directly or indirectly in export activities. Estimates have been put forward that each $1 billion of exports adds 60,000 new jobs to the American economy. It is thus obvious maintaining a strong export position and a positive trade balance are extremely important to sustaining domestic employment. One school of thought contends the two-and-a-half-fold increase in American imports that has occurred from 1971, when DISC was put into being, through 1975, came about strictly because of the floating exchange rate for the dollar established in 1971. We certainly agree it has been helpful to exporters to have a lower parity with most foreign currencies. We do not agree this obviates the need for DISC. That which floats can float up as well as down. DISC advantages on

the contrary are within our own control, are quantifiable and can have whatever element of permanence Congress is willing to let it have.

Summing up, DISC has been of very great help to this country in improving our trade conditions, in providing jobs, in placing an important prop under the domestic economy and increasing Federal tax revenues through a higher level of economic activity than would otherwise apply.

In view of these impressive benefits, our recommendations are before your committee to reject the modification of the DISC called for in H.R. 10612. This bill as finally adopted would make future DISC benefits available only for certain incremental exports and exclude certain commodities. We believe that it would reduce DISC benefits about 60 percent in the first year. This is about twice the reduction estimated by the Ways and Means Committee when it finally passed on this particular proposal last December.

Under the House proposal, DISC treatment would apply to 75 percent of the company's export income in excess of the average over and above the average 3-year base period of 1972, 1973, 1974, but after 5 years, it becomes a rolling base. The rolling base concept magnifies all of the problems pointed out by the Treasury and public witnesses in testimony before this committee in 1971. The most significant problem will be the effect of moving base on cyclical movements and export sales.

The House bill also specifically excluded agricultural products from DISC on the grounds the incentive was no longer needed due to high demand abroad. A 50-percent value added from manufacturing test which was applied and only agricultural products meeting the 50-percent test would continue to qualify for DISC treatment. We agree with the beef exporters from whom you have just heard that there is no reason to discriminate against the agricultural sector of our economy by excluding the products from DISC. If a particular commodity becomes in short supply, the already existing provisions provide for its removal from DISC treatment. Agricultural commodities are the primary U.S. export resource which can be used to offset the exorbitant price levels established by international bodies controlling the price of raw materials such as oil. At the same time, the expansion and modernization of agricultural facilities due to world demand will create more efficient production of agricultural commodities and reduce the cost to domestic consumers, a most important benefit.

The House bill excludes military products as well. The sale of military products is a significant factor to the U.S. economy and U.S. employment. The same economic and employment benefits are defined from the export of any other U.S.-produced goods. We feel that action of the House to exclude such sales from DISC treatment was unduly discriminating and a mistake.

Other industrial nations strongly encourage sales of military products by their manufacturers and provide major competition to U.S. companies. Even when the U.S. Government is an intermediary in the sale of a product, the U.S. manufacturer is required to expend considerable time and funds in obtaining the final contract. Thus, military sales are subject to severe competition equal to or greater than other U.S. exports and should not be singled out for separate treatment.

Any decision with respect to the merits of sales of military products involves consideration of the Foreign Military Sales Act. The tax code is not the proper place to legislate on the merits of military sales.

The membership of our special committee and those associations which have joined in formulating and supporting its objectives recommend that the House amendments to the Domestic International Sales Corporation provision of the Internal Revenue Code be rejected in their entirety.

Specifically our committee recommends now that existing provisions remain in effect as a permanent feature of the Internal Revenue Code and in the long run, they should be expanded to the 100-percent deferral as originally proposed by the Treasury in 1970 as opposed to the 50-percent deferral that was eventually adopted. We recommend no exclusions be provided other than those already in the law for the purpose of insuring adequate domestic supplies of certain commodities.

Finally, we recommend that consideration be given to simplification of procedures for establishing and operating a DISC subsidiary so that additional small firms will be encouraged to participate and to assist in meeting national export goals.

Thank you, sir.

Senator TALMADGE. I judge the thrust of your statement is rather than being a loophole, DISC actually generates more taxes than we would otherwise collect, due to increased exports and job opportunities in this country.

Mr. GARFIELD. Yes. The Departments of Treasury and Commerce have both made statements to the effect that they feel that exports derived from DISC, in other words, which would not have existed were it not for DISC are of an order of magnitude of $6 billion. There is this multiplier effect of about $3 since all of the commodities exported are basic. We can't export a policeman or haircut or other type of service, so anything that is exported gives rise to supporting service activities.

The Federal revenues are abount 23 percent of the gross national product. Therefore the $6 billion times 3-for-1 impact on GNP has lead to an $18 billion increase; and 23 percent of that is as much as $4.1 billion in tax revenues as opposed to the so-called revenue cost of $1.3 billion last year for DISC.

Senator TALMADGE. Senator Curtis.

Senator CURTIS. I want to commend you for your fine statement. I have glanced at appendix A to your statement. It is a very impressive list of business concerns that employ tens and tens of thousands of Americans. Indeed, some of our very important businesses are listed here.

In your opinion, what has DISC done for small business?

Mr. GARFIELD. Perhaps we could ask Mr. Sauereisen, who is in fact a small businessman. He has been very active in our committee since the beginning and I will defer to him on that question, if I may.

Mr. SAUEREISEN. Thank you, Senator.

As past president of an organization of approximately 650 small companies, as president of a DISC company and as Small Business Person of the Year from the Commonwealth of Pennsylvania, I urge

and strongly plead that DISC be retained and, when possible, increased to 100 percent tax deferral because we find in small companies, Senator, that DISC usually provides the only incentive for small companies to export. It is just recently that the word and the expertise has filtered down to many small companies enabling them to form DISC's.

Through our DISC, Sauereisen Exports, Inc., in the 2 years we have had DISC our export sales have increased 38 percent and our employment has increased 35 percent and our tax revenues have increased substantially more.

Lastly, in the first year our tax deferral, which in practice, Senator, is only 25 percent, our tax deferral amount was only $2,700, and the second year was only $7,200. That little amount of tax deferral—and that is not tax evasion, only tax deferral—increased employment and revenue so substantially that small companies do need DISC.

I thank you for this opportunity.

Senator CURTIS. Does the activity created by DISC add or detract from the overall total of Government revenues?

Mr. SAUEREISEN. It definitely adds, Senator.

Senator CURTIS. Therefore, the repeal of DISC will not make it possible to extend tax relief to other taxpayers, will it?

Mr. SAUEREISEN. That is correct.

Senator CURTIS. Instead, repeal of DISC will increase their burden. Do you agree?

Mr. SAUEREISEN. Yes.

Senator CURTIS. I would like to ask the panel whether you agree with the recommendation made by Senator Kennedy, when he appeared before this committee earlier, that DISC should be completely repealed. Does anybody wish to comment on that?

Mr. GARFIELD. I think personally it would be a disaster. It would certainly be interpreted by us as a wish on the part of Congress that we deemphasize exports. I don't see what other interpretation could be placed on it. It was only relatively a few years ago that I think we as a country recognized we were in a very serious position. We were in the red in our entire national accounts and we were facing, as we did not realize at that time, an enormous increase in the costs of imported energy. That was not perceived in 1971.

I might just mention our fuel imports for 1972 were 3.7 billion. Last year fuel imports were something in the range of 27 billion. It ought to be borne in mind that this surge of imports is not always shoes and things of that type that could have been made here but basically the types of commodities we do not have ourselves and need.

Senator CURTIS. What about employment? Would the repeal of DISC mean fewer jobs in this country or more jobs?

Mr. GARFIELD. Fewer jobs.

Senator CURTIS. Do you agree?

Mr. SAUEREISEN. Fewer jobs, because DISC allows us to do in this country what formerly we had to go abroad to do, to create jobs and tax revenues in foreign countries. Now DISC permits this in our own country where it should be.

Mr. GARFIELD. Senator Curtis, if I could have one more minute, it may be interesting to look at one little arrow shot. I have the figures for my own company. My own company is the Ingersoll-Rand Co., which is a substantial exporter. For the several years preceding 1971 when DISC was passed, we had 18 percent of our employees engaged in export. During the last few years we have been able to expand employment quite considerably, and that percentage of our employees, all employees in the United States employed in export, has risen to 25 percent.

Stated in numbers, we had 3,700 export jobs in my company in 1971. We had 6,500 last year, and that has accounted for substantially all of our increase in domestic employment.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. Senator Curtis asked about the size of the companies. I note in your statement, Mr. Garfield, you say that a Treasury analysis showed that for the first full year of experience, June 1972 to June 1973, 50 percent of the companies forming DISC's had assets of less than $10 million and 14 percent of these had assets of less than $1 million.

I think that ought to be interesting to a lot of people who may have had different ideas.

I would like to ask, Mr. Chairman, that if it would not be too big a job, and I have no illusions about that, I think it would be very helpful to the Congress if Mr. Garfield could identify the companies listed in appendix A, showing the different States in which those companies may operate. Also, the question arises where do the benefits go. I should think that that nine-page listing there of export-supporting companies would be of greater interest if we could have a breakdown.

Senator TALMADGE. If you will submit that for the record we will be happy to include it.

[The following was subsequently submitted for the record:]

SPECIAL COMMITTEE FOR U.S. EXPORTS

MEMBER COMPANIES' PLANT LOCATIONS BY STATE

Alabama

Albany Int'l. Corp. (1)
Aspro, Inc. (1)
Cook Industries, Inc. (1)
Den-Tal-Ez Mfg. Co. (1)
Dupont (1)
Eastern Air Lines Inc. (4)
The Foxboro Company (2)
Koppers Company, Inc. (1)
Monsanto Company (3)
Southern Aluminum Castings Co.
Southern Industries Corp.
Sundstrand Corp. (1)
TRW, Inc. (2)

Alaska

Whitney-Fidalgo Seafoods, Inc. (8)

Arizona

Albany Int'l. Corp. (1)
Beech Aircraft Corp.
The Black & Decker Mfg. Co. (1)
Rogers Corp.
San Fernando Electric Mfg. Co.
Southwest Forest Industries, Inc.
TRW, Inc. (1)

Arkansas

American Hoist & Derrick Co. (1)
Cook Industries, Inc. (1)
Dupont (1)
Eaton Corp. (1)
Franklin Electric (2)
Gould, Inc. (1)
Ingersoll-Rand Company (1)
Jacuzzi Bros., Inc. (2)
Koppers Company (2)
Monsanto Company (1)
TRW, Inc. (3)

California

American Microsystems, Inc.
American Telecommunications Corp.
Armco Steel (4)
Atlantic Richfield Co.
Baker Int'l. Corp.
Bandag Inc. (3)
Beckman Instruments, Inc.
Beech Aircraft Corp. (10)
Bentley Laboratories, Inc.
Bertea Corp.
The Black & Decker Mfg. Co.
Calbiochem
Celanese Corp. (1)
Coherent Radiation
Consyne Corp.
Cook Industries, Inc. (1)
Craig Corp.
Crocker National Bank
Cyprus Mines Corp.
Dataproducts Corp.
Den-Tal-Ez Mfg. Co. (1)
Dentsply Int'l. Inc. (2)
Donaldson Co., Inc. (1)
Dupont (4)
Eastern Air Lines, Inc. (1)
Eastman Kodak Company (6)
Eaton Corp. (1)
Envirotech
Fibreboard Corp.
Flying Tiger Line, Inc.
The Foxboro Company (2)
The Garrett Corp.
Gould Inc. (2)
Guardian Packaging Corp.
Hesston Corp. (1)
Hoffman Electronics Corp. (1)
Ingersoll-Rand Company (2)
Inland Container Corp. (4)
Knogo Corp. (2)
Lear Siegler, Inc. (3)
Lee Pharmaceuticals
Levi Strauss & Co.
Lockheed Aircraft Corp. (4)
Lukens Steel Company (1)
Measurex Corp. (1)
Merck & Co., Inc. (7)
Michigan General Corp. (1)
Monsanto Company (5)
Norris Industries (7)
Northrop Corp.
PVO Int'l., Inc.
Pacific Lumber Co.
The Ralph M. Parsons Co.
Pertec Corp.
Rogers Corp. (1)
Rohr Industries, Inc.
Rucker Company
San Fernando Electric Mfg. Co. (1)
Spectra-Physics, Inc.
Standard Oil Co. of California
Sundstrand Corp. (3)
Sweco, Inc.
Systron-Donner Corp.
Tab Products Company (2)
The Toro Company (5)
TRW, Inc. (31)
Union Oil Company of California
Union Special Corp. (1)
United Technologies Corp.
Upjohn Company (2)
VSI Corp.
Varian Associates
Vetco Offshore Industries Inc. (1)
Watkins-Johnson Company (2)
Western Bancorporation
Western Gear Corp.
Wolff Mfg. Company
Wynn's Int'l., Inc.

Colorado

Beech Aircraft Corp. (2)
Cobe Laboratories, Inc. (1)
Columbine Int'l. Corp.
Dupont (1)
Eastman Kodak Company (1)
Eberline Instrument Corp. (1)
The Eversman Mfg. Co.
Fenton Int'l., Inc.
The Foxboro Company (1)
Gould Inc. (1)
Hesston Corporation (1)
Johns-Manville Corp.
Lear Siegler, Inc. (1)
Michigan General Corp. (1)
Portec Inc. (1)
Sundstrand Corp. (1)
TRW, Inc. (5)
Valleylab, Inc.
Windsor Industries, Inc.

Connecticut

Albany Int'l. Corp. (2)
American Can Company
Aspro, Inc. (1)
Beech Aircraft Corp. (2)
Beker Industries Corp.
Condec Corp.
Dupont (2)
Louis Dreyfus Corp.
Echlin Mfg. Co.
The Foxboro Company (1)
General Cable Corp.
General Electric
General Telephone & Electronics Corp. (1)
Gould Inc. (1)
Hooker Chemicals & Plastics Corp.
Ingersoll-Rand Company (2)
Kollmorgen Corp. (1)
Koppers Company
La Pointe Industries
Monsanto Company (4)
Moore Special Tool Co.
Olin Corp. (1)
Remington Arms Co., Inc.
Rogers Corp. (5)
Stauffer Chemical Company
TRW, Inc. (5)
United Technologies Corp.
Upjohn Company (1)

Delaware

Dentsply Int'l. Inc. (1)
Dupont (6)
Hercules, Inc.
Inland Container Corp. (1)

Florida

Bandag Inc. (3)
Beech Aircraft Corp. (3)
Dentsply Int'l. Inc. (1)
Dupont (1)
Eastern Air Lines Inc. (15)
Eaton Corp. (1)
The Foxboro Company (1)
Gould Inc. (1)
Harris Corp. (2)
Inland Container Corp. (1)
Knogo Corp. (1)
Koppers Company (2)
Michigan General Corp. (1)
Millmaster Onyx Corp. (2)
Monsanto Company (1)
Sealt-Sweet Int'l.
Sunair Electronics, Inc.
TRW, Inc. (5)
Union Special Corp. (1)
United Technologies

Georgia

American Hoist & Derrick Co. (1)
Beech Aircraft Corp. (3)
Celanese Corp. (1)
Dentsply Int'l. Inc. (1)
Dupont (3)
Eastern Air Lines, Inc. (4)
Eastman Kodak Company (2)
Eaton Corp. (2)
Flowers Industries, Inc.
The Foxboro Company (1)
Glasrock Products, Inc.
Hesston Corp. (1)
Inland Container Corp. (2)
Knogo Corp. (1)
Lukens Steel Company (1)
Lummus Industries, Inc.
Lockheed Aircraft Corp. (1)
Merck & Co., Inc. (1)
Millmaster Onyx Corp. (1)
Monsanto Company (3)
Peachtree Doors, Inc.
Scientific-Atlanta, Inc.
TRW, Inc. (4)
The Toro Company (1)
Union Special Corp. (1)
Upjohn Company (1)

Hawaii

Eastman Kodak Company (1)
The Foxboro Company (1)

Idaho

Monsanto Company (1)

Illinois

American Hospital Supply Corp.
Beech Aircraft Corp. (2)
Bliss & Laughlin Industries, Inc.
Chemetron Corp.
Chicago Bridge & Iron Co.
Comdisco, Inc.
Container Corp. of America
Cook Industries, Inc. (1)
Deere & Company (1)
Dentsply Int'l. Inc. (1)
A. B. Dick Company
Donaldson Co., Inc. (2)
Dreis & Krump Mfg. Co.
Dupont (2)
Eastern Air Lines, Inc. (1)
Eastman Kodak Company (2)
Eaton Corp. (10)
Eberline Instrument Corp. (1)
Elgin National Industries, Inc.
Esmark, Inc.
FMC Corp.
The Foxboro Company (2)
Galaxy Carpet Mills, Inc.
Gould Inc. (2)
Grotnes Machine Works, Inc.
Harris Corp. (1)
Harris Trust & Savings Bank
Hesston Corp.
Illinois Tool Works, Inc.
The Ingersoll Milling Machine Co.
Ingersoll-Rand Company (3)
Inland Container Corp. (1)
International Harvester Co.
Richard D. Irwin, Inc.
Keystone Consolidated Industries, Inc.
Knogo Corp.
Libby, McNeill & Libby (1)
The Lockformer Company
Ludlow Industries, Inc.
Lukens Steel Company (1)
Marsh Stencil Machine Co.
McGraw-Edison Co.
Merck & Co., Inc. (1)
Michigan General Corp. (2)
Millmaster Onyx Corp. (2)
Monsanto Company (1)
Motorola, Inc.
Northern Natural Gas Co.
Oak Industries Inc.
Portec, Inc. (3)
Refrigerating Specialties Company
Rogers Corp. (1)
Roper Corp.
Signode Corp.
Skil Corp.
Stanray Corp.
Stewart-Warner Corp.
Sundstrand Corp. (4)
TRW, Inc. (16)
Toro Company (1)
Union Special Corp. (4)
United Technologies Corp.
Universal Oil Products Co.
Valley Industries, Inc. (7)
Victor Comptometer Corp.

Indiana

Albany Int'l. Corp. (1)
American Hoist & Derrick Company (2)
Beech Aircraft Corp. (5)
The Carborundum Company (1)
Dupont (8)
Eastern Air Lines, Inc. (2)
Eaton Corp. (4)
E-Systems, Inc. (1)
Franklin Electric (1)
Gould, Inc. (2)
Great Lakes Chemical Corp.
Hesston Corp. (1)
Ingersoll-Rand Company (3)
Inland Container Corp. (4)
Lear Siegler, Inc. (1)
Eli Lilly & Company
Millmaster Onyx Corp. (1)
Monsanto Company (1)
Portec Inc. (1)
Sundstrand Corp. (1)
TRW, Inc. (5)
Tecumseh Products Co. (1)
United Technologies

Iowa

American Hoist & Derrick Company (1)
Bandag Inc. (3)
Beech Aircraft Corp. (1)
Cook Industries, Inc. (1)
Den-Tal-Ez Mfg. Co. (1)
Donaldson Co., Inc. (3)
Dupont (2)
Eaton Corp. (2)
Hach Chemical Co.
Lear Siegler, Inc. (1)
Massey-Ferguson Inc.
Monsanto Company (3)
Sundstrand Corp. (1)
TRW, Inc. (1)

Kansas

Beech Aircraft Corp. (7)
Cessna Aircraft Co.
Cook Industries, Inc. (1)
Dupont (1)
The Foxboro Company (2)
Gould Inc. (1)
Hesston Corp. (3)
Ingersoll-Rand Company (1)
Inland Container Corp. (1)
United Technologies

Kentucky

Ajax Magnethermic Corp. (1)
Ashland Oil, Inc.
Bandag Inc. (1)
Celanese Corp. (3)
Dibrell Brothers, Inc. (1)
Dupont (2)
Eastern Air Lines, Inc. (3)
Eaton Corp. (5)
Ingersoll-Rand Company (2)
Merck & Co., Inc. (1)
Portec Inc. (1)
Porter Paint Company
Rohm & Haas Company (1)
Tecumseh Products Co. (1)
United Technologies

Louisiana

Dupont (3)
Eastern Air Lines, Inc. (1)
The Foxboro Company (3)
Gould Inc. (1)
Monsanto Company (1)
Newpark Resources, Inc. (1)
Southern Industries Corp.
TRW, Inc. (1)
United Technologies Corp.
Valley Industries, Inc. (1)
T. K. Valve Mfg. Inc.

Maine

Albany Int'l. Corp (2)
American Hoist & Derrick Company (1)
The Foxboro Company (1)
Marine Colloids Int'l. Inc. (1)

Maryland

Armco Steel Corp. (4)
The Black & Decker Mfg. Co. (3)
The Carborundum Company (1)
Celanese Corp. (1)
The Chesapeake Corp. of Virginia (1)
Eastern Air Lines, Inc. (1)
Eastman Kodak Company (1)
The Foxboro Company (1)
Gould Inc. (1)
Knogo Corp. (1)
Koppers Company (2)
Martin-Marietta Corp.
Merck & Co., Inc. (1)
Millmaster Onyx Corp. (1)
TRW, Inc. (1)
Watkins-Johnson Company (1)
Waverly Press, Inc.
Westinghouse Electric Corp.

Massachusetts

Addison-Wesley Publishing Co.
Albany Int'l. Corp. (2)
Analog Devices, Inc.
Augat, Inc. (7)
Beech Aircraft Corp. (1)
Cincinnati Milacron Inc. (1)
Corenco Corp.
Denninson Mfg. Co.
Digital Equipment Corp.
Dupont (1)
Eastern Air Lines, Inc. (2)
Eastman Kodak Company (2)
The Foxboro Company (4)
Gloucester Engineering Co., Inc.
Gould Inc. (1)
Incoterm Corp.
Ingersoll-Rand Company (1)
Instrumentation Laboratory, Inc.
Knogo Corp. (1)
Kollmorgen Corp. (1)
Leesona Corp. (1)
Ludlow Corp.
Lukens Steel Company (1)
Millmaster Onyx Corp. (1)
Monsanto Company (2)
Morgan Construction Company
Norris Industries (1)
Pneumo Corp.
TRW, Inc. (10)
Thermo Electron Corp. (3)
Union Special Corp. (1)
United Technologies
Valley Industries, Inc. (1)
Wyman-Gordon Company

Michigan

American Hoist & Derrick Company (3)
Aspro, Inc. (1)
Bandag Inc. (3)
The Bendix Corp.
Brooks & Perkins, Inc.
The Budd Company
Celanese Corp. (1)
Clark Equipment Company
A. T. Cross Company
Dow Chemical Company
Dupont (2)
Eastern Air Lines, Inc. (1)
Eastman Kodak Company (1)
Eaton Corp. (7)
Federal Mogul
The Foxboro Company (1)
Franklin Electric (1)
Gould Inc. (1)
Hoover Ball & Bearing Co.
Ingersoll-Rand Company (1)
Kirsch Co.
Knogo Corp. (1)
Kuhlman Corp.
Lear Siegler, Inc. (4)
Lukens Steel Company (1)
McCord Corp.
Merck & Co., Inc. (1)
Michigan General Corp. (2)
Michigan Seamless Tube Co.
Modern Industrial Engineering Co.
Monsanto Company (1)
Norris Industries (1)
Portec Inc. (1)
Sealed Power Corp.
Sundstrand Corp. (1)
Sycor, Inc.
TRW, Inc. (8)
Tecumseh Products Co. (2)
Thermo Electron Corp. (2)
The Toro Company (1)
United Technologies Corp.
Upjohn Company (1)
Valeron Corp.
Wolverine World Wide Inc.

Minnesota

American Hoist & Derrick Co. (6)
Apache Corp.
Beech Aircraft Corp. (1)
Cook Industries, Inc. (2)
Data Card Corp.
Donaldson Co., Inc. (2)
Dupont (1)
Eastern Air Lines, Inc. (2)
Eaton Corp. (1)
Electro-Craft Corp.
The Foxboro Company (1)
H. B. Fuller Company
General Mills, Inc. (1)
Gould, Inc. (2)
Hesston Corp. (1)
Honeywell Inc.
Knogo Corp. (1)
Lear Siegler, Inc. (2)
Magnetic Controls Company (3)
Napco Industries, Inc. (1)
Northrup, King & Co.
Northwest Airlines, Inc.
Peavey Company
Portec Inc. (1)
Possis Corp.
RayGo, Inc. (2)
Rosemount, Inc.
Tonak Corp. (3)
Toro Company (2)
TRW, Inc. (2)
Van Dusen Air Inc.

Mississippi

Aspro, Inc. (1)
Cook Industries, Inc. (3)
Delta & Pine Land Co.
Dupont (1)
Gould Inc. (2)
Inland Container Corp. (1)
Marathon Mfg. Co. (1)
Tyrone Hydraulics, Inc.

Missouri

Alvey Inc. (1)
Beech Aircraft Corp. (3)
Chromalloy American Corp.
Cook Industries, Inc. (2)
Donaldson Co., Inc. (2)
Dupont (1)
Eastern Air Lines, Inc. (1)
Eaton Corp. (3)
Emerson Electric Co.
The Foxboro Company (1)
General Dynamics Corp.
Gould Inc. (1)
Inland Container Corp. (1)
Knogo Corp. (1)
Lukens Steel Company (1)
McDonnell Douglas Corp.
Merck & Co., Inc. (1)
Michigan General Corp. (1)
Monsanto Company (4)
Sundstrand Corp. (1)
TRW, Inc. (4)
Tiffany Industries, Inc.
Valley Industries, Inc. (5)

Montana

American Hoist & Derrick Company (1)

Nebraska

Beech Aircraft Corp. (1)
Eastern Air Lines, Inc. (1)
Eaton Corp. (1)
Gould Inc. (1)
Hy-Gain Electronics Corp.
Inland Container Corp. (1)
Instrumentation Specialties Co., Ltd.
Northern Natural Gas Co.
TRW, Inc. (4)

Nevada

Beech Aircraft Corp. (1)

New Hampshire

Centronics Data Computer Corp.
Ingersoll-Rand Company (1)
Merck & Co., Inc. (1)
Rogers Corp. (1)
United Technologies

New Jersey

American Hoist & Derrick Company (1)
The Bates Mfg. Co. (1)
Beech Aircraft Corp. (1)
Celanese Corp. (1)
Classic Chemicals Company
Congoleum Corp.
Datascope Corp. (1)
Dupont (7)
Eastern Air Lines, Inc. (1)
Eastman Kodak Company (1)
Eaton Corp. (2)
Egan Machinery Co. (1)
Federal Paper Board Co., Inc.
Fisher Scientific Co.
Foster Wheeler Corp.
The Foxboro Company (1)
GAF Corp.
Sylvan Ginsbury, Ltd.
Gould Inc. (1)
Inland Container Corp. (1)
International Telephone & Telegraph Corp.
Ingersoll-Rand Company (2)
Koppers Company (1)
Lear Siegler, Inc. (1)
Lockheed Aircraft Corp. (1)
Lukens Steel Company (1)
Marine Colloids Int'l. Inc. (1)
MEM Company, Inc. (1)
Merck & Co., Inc. (2)
Millmaster Onyx Corp. (8)
Monsanto Company (5)
Norris Industries (1)
Prentice-Hall, Inc.
Soundesign Corp. (1)
TRW, Inc. (9)
Union Camp Corp.

New Mexico

Eberline Instrument Corp. (2)

New York

Albany Int'l. Corp. (6)
Allied Chemical Corp.
American Export Lines, Inc. (1)
American Hoist & Derrick Company (1)
American Precision Industries, Inc. (2)
Anaconda Company
Aspro, Inc. (2)
Astrosystems, Inc.
Avnet, Inc.
Babcock Industries (2)
Bandag Inc. (5)
The Bank of New York
C. R. Bard, Inc.
Bausch & Lomb
Beech Aircraft Corp. (5)
The Black & Decker Mfg. Co. (1)
Borden Inc.
Bunge Corp.
The Carborundum Company (4)
Carrier Corp.
Celanese Corp. (1)
The Chesapeake Corp. of Virginia (1)
Chicago Pneumatic Tool Co.
Cluett, Peabody & Co., Inc.
Colt Industries Inc.
Columbus McKinnon Corp.
Continental Grain Company
Corning Glass Works
Crompton & Knowles Corp.
Crouse-Hinds Co.
Dentsply Int'l. Inc. (2)
Dupont (3)
Eastern Air Lines, Inc. (6)
Eastman Kodak Company (2)
Eaton Corp. (1)
The Foxboro Company (4)
GAF Corp.
Garlock, Inc.
General Host Corp.
Geon Industries, Inc. (2)
Gleason Works (1)
Gould Inc. (1)
Gruman Corp.
Harper & Row, Publishers, Inc.
Harris Corp. (3)
Henningsen Foods, Inc.
Hesston Corp. (1)
Indian Head Inc.
Ingersoll-Rand Company (2)
Int'l. Flavors & Fragrances, Inc.
Int'l. Paper Co.
Int'l. Telephone & Telegraph Corp.
Kewanee Industries, Inc.
Knogo Corp.
Kollmorgen Corp. (2)
Koppers Company (1)
Lincoln First Banks, Inc. (5)
Lockheed Aircraft Corp. (1)
Lukens Steel Company (1)
Macmillan, Inc.
Michigan General Corp. (2)
Millmaster Onyx Corp. (2)
Monsanto Company (1)
Moog Inc.
NL Industries, Inc.
National Distillers & Chemical Corp.
North American Philips Corp.
Pan American Trade Development Corp.
Peabody-Galion Corp.
Portec Inc. (1)
RCA Corp.
Reichhold Chemicals, Inc.
Rogers Corp. (1)
Seagrave Corp. (1)
Seatrain Lines, Inc.
The Singer Company
Sperry Rand Corp.
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Sun Chemical Corp.
Sundstrand Corp. (1)
Supreme Equipment & Systems Corp.
TRW, Inc. (10)
The Toro Company (1)
Union Carbide Corp.
Union Special Corp. (1)
Uniroyal, Inc.
United Industrial Corp.
U. S. Industries, Inc.
United States Filter Corp.
United Technologies Corp.
Valley Industries, Inc. (1)
Wallace-Murray Corp.
Wheelabrator-Frye Inc.

North Carolina

Akzona, Inc.
Albany Int'l. Corp. (1)
Bandag Inc. (8)
Beech Aircraft Corp. (1)
The Black & Decker Mfg. Co. (2)
Celanese Corp. (4)
The Chesapeake Corp. of Virginia (1)
Cone Mills Corp.
Cook Industries, Inc. (1)
Dibrell Brothers, Inc. (1)
Dupont (5)
Eastern Air Lines, Inc. (6)
Eaton Corp. (6)
The Foxboro Company (1)
Ingersoll-Rand Company (1)
Koppers Company
W. D. Lawson & Company
Rogers Corp. (1)
Rohm & Haas Company (1)
TRW, Inc. (4)
United Technologies Corp.
Wachovia Bank & Trust Company, N.A. (182)

Ohio

A–T–O Inc.
Acme-Cleveland Corp.
Ajax Magnethermic Corp. (3)
American Hoist & Derrick Co. (1)
Anchor Hocking Corp.
Armco Steel Corp.
Aro Corp.
Aspro, Inc. (2)
Bandag Inc. (9)
Beech Aircraft Corp. (3)
The Black & Decker Mfg. Co. (1)
Celanese Corp. (1)
Cincinnati Milacron Inc. (6)
Commercial Shearing, Inc.
Copeland Corp.
Dayco Corp.
Den-Tal-Ez Mfg. Co. (1)
Dentsply Int'l. Inc. (3)
Diamond Shamrock Corp.
Dupont (4)
The Duriron Company, Inc.
Eagle-Picher Industries, Inc.
Eastern Air Lines, Inc. (3)
Eastman Kodak Company (2)
Eaton Corp. (4)
Emery Industries, Inc.
The Foxboro Company (2)
Gilford Instrument Laboratories, Inc.
Gorman-Rupp Co.
Gould Inc. (6)
Harris Corp. (2)
Hobart Corp.
Inland Container Corp. (2)
Int'l. Paper Co.
Kewanee Industries Inc. (1)
Koppers Company (1)
Lear Siegler, Inc. (2)
Lukens Steel Company (2)
Marion Power Shovel Co., Inc.
Mead (1)
Michigan General Corp. (1)
Midland-Ross Corp.
Millmaster Onyx Corp. (1)
The Mogul Corp. (1)
The Monarch Machine Tool Company
Monsanto Company (5)
Peabody-Galion Corp.
Portec Inc. (2)
Production Machinery Corp.
Reliance Electric Company
Republic Steel Corp.
A. Schulman, Inc.
Sugardale Foods, Inc.
Sun Chemical Corp.
Sundstrand Corp. (2)
TRW, Inc. (19)
Tecumseh Products Co. (2)
Tappan Company
United Technologies Corp.
Valley Industries, Inc. (1)
Van Dorn Company
The Warner & Swasey Company (1)
Weatherhead Company
White Motor Corp.

Oklahoma

American Hoist & Derrick Co. (1)
Beech Aircraft Corp. (1)
Born Export Corp.
Braden Industries, Inc.
Donaldson Co., Inc. (1)
Dupont (1)
The Foxboro Company (2)
Ingersoll-Rand Company (1)
Hesston Corp. (2)
Kendavis Industries Int'l. Inc.
Sola Basic
TRW, Inc. (3)
Williams Companies

Oregon

Beech Aircraft Corp. (2)
Bohemia Inc. (1)
Cook Industries, Inc. (1)
Eastern Air Lines, Inc. (1)
The Foxboro Company (1)
Georgia-Pacific Corp.
Gould Inc. (1)
Hesston Corp. (2)
Ingersoll-Rand Company (1)
Louisiana-Pacific Corp.
Monsanto Company (1)
Pope & Talbot, Inc. (1)
Pugh & Company
RayGo, Inc.
TRW, Inc.

Pennsylvannia

Acker Drill Company, Inc. (1)
Ag-Met, Inc.
Air Products & Chemicals, Inc.
Ajax Magnethermic Corp. (1)
Allegheny Ludlum Industries, Inc.
American Hoist & Derrick Company (1)
American Medicorp Inc.
Armco Steel Corp. (2)
Aspro, Inc. (1)
Bandag, Inc. (5)
Beech Aircraft Corp. (6)
Belmot Industries, Inc.
The Black & Decker Mfg. Co. (1)
Carpenter Technology Corp.
The Chesapeake Corp. of Virginia (2)
Copperweld Corp.
Dentsply Int'l. (1)
Dupont (9)
ESB, Inc.
Eastern Air Lines, Inc. (3)
Eastman Kodak Company (1)
Eaton Corp. (3)
Extracorporeal Medical Specialties Inc.
Fischer & Porter (1)
Fisher Scientific Co.
The Foxboro Company (2)
Franklin Electric Co., Inc. (1)
Gould Inc. (1)
Grove Mfg. Co.
Hammermill Paper Co.
Hankison Corp.
Harris Corp. (1)
Horix Mfg. Co. (1)
Ingersoll-Rand Company (9)
Inland Container Corp. (2)
Joy Mfg. Co.
Kennametal Inc. (1)
Kewanee Oil Company (1)
Knogo Corp. (1)
Koppers Company (6)
Lord Corp.
Lukens Steel Company (2)
MEM Company, Inc. (1)
Merck & Co., Inc. (5)
Mine Safety Appliances Co.
Monsanto Company (1)
Narco Scientific Industries, Inc.
National Forge Company
Piper Aircraft Corp.
H. H. Robertson Co.
Rockwell Int'l.
Rohm & Haas Company (3)
Sauereisen Cements Company
Spang & Company
Spang Industries, Inc.
Steelmet, Inc.
Jacob Stern & Sons, Inc.
TRW, Inc. (10)
The Toro Company (1)
Union Special Corp. (1)
United Technologies Corp.
Upjohn Company (1)
Valley Industries, Inc. (1)
Vesuvius Crucible Company (1)
Wean United Inc.
Weld Tooling Corp.
Westinghouse Electric Corp.
Zurn Industries, Inc.

Rhode Island

Albany Int'l. Corp. (1)
The Cross Company
Eastern Air Lines, Inc. (1)
The Foxboro Company
Harris Corp. (1)
Leesona Corp. (1)
Mine Safety Appliances Co. (1)
United Technologies Corp.
Valley Industries, Inc. (1)

South Carolina

Beech Aircraft Corp. (1)
Celanese Corp. (4)
Cook Industries, Inc. (1)
Dupont (4)
Eastern Air Lines, Inc. (3)
Eastman Kodak Company (1)
Eberline Instrument Corp. (1)
E-Systems, Inc. (1)
The Foxboro Company (1)
Graniteville Co.
Ingersoll-Rand Company (1)
Inland Container Corp. (1)
Leesona Corp. (1)
Monsanto Company (3)
Sonoco Products Co.
TRW, Inc. (1)
United Technologies Corp.

Tennessee

American Precision Industries Inc. (1)
Bandag Inc. (1)
Beech Aircraft Corp. (2)
Buckman Laboratories, Inc.
The Carborundum Company (1)
Conwood Corp.
Cook Industries, Inc. (2)
W. B. Dunavant & Co.
Dupont (5)
Eastern Air Lines, Inc. (3)
Eastman Kodak Company (1)
Eaton Corp. (4)
The Foxboro Company (2)
Gould Inc. (6)
Inland Container Corp. (1)
Lear Siegler, Inc. (1)
Monsanto Company (1)
Portec Inc. (1)
Rohm & Haas Company (1)
TRW, Inc. (7)
United Technologies Corp.

Texas

Alcon Laboratories, Inc. (1)
American Hoist & Derrick Co. (1)
Anderson Greenwood & Co.
Armco Steel Corp. (7)
Bandag Inc. (1)
Beech Aircraft Corp. (13)
Bowen Tools, Inc.
Cleanese Corp. (5)
Cook Industries, Inc. (2)
Daniel Industries, Inc.
Datapoint Corp.
Dentsply Int'l. Inc. (1)
Dresser Industries, Inc.
Dupont (5)
E-Systems, Inc. (4)
Eastern Air Lines, Inc. (4)
Eastman Kodak Company (2)
Farah Mfg. Co., Inc.
The Foxboro Company (6)
Galveston-Houston Co.
Gardner-Denver Co.
Gould Inc. (2)
Harris Corp. (2)
Hesston Corp. (1)
Hughes Tool Company
Ingersoll-Rand Company (2)
Inland Container Corp. (1)
Knogo Corp. (1)
The LTV Corp.
Lockheed Aircraft Corp. (2)
Lukens Steel Company (1)
Marathon Mfg. Co. (3)
Merck & Co., Inc. (1)
Michigan General Corp. (6)
Millmaster Onyx Corp. (1)
Monsanto Company (2)
Reed Tool Company
Riviana Foods Inc.
Rohm & Hess Company (1)
Sundstrand Corp. (1)
TRW, Inc. (10)
Starke Taylor & Son, Inc.
Texas Eastern Transmission Corp.
Union Special Corp. (1)
United Technologies Corp.
Upjohn Company (1)
Valley Industries, Inc. (4)
Vetco Offshore Industries Inc. (1)
Whiteall Electronics Corp.

Utah

E-Systems Inc. (1)
Hesston Corp. (1)
TRW, Inc. (1)
United Technologies Corp.

Vermont

The Foxboro Company (1)

Virginia

Beech Aircraft Corp. (2)
The Bendix Corp.
The Carborundum Company (1)
Celanese Corp. (1)
The Chesapeake Corp. of Virginia (2)
Dibrell Brothers, Inc. (2)
Dupont (4)
E-Systems, Inc. (2)
Eastern Air Lines, Inc. (1)
Eaton Corp. (2)
Ethyl Corp.
The Foxboro Company (1)
Gould Inc. (1)
Grumman Corp.
Harris Corp. (1)
Honeywell Inc.
ICA Export Co., Inc.
Ingersoll-Rand Company (1)
Kollmorgen (1)
Merck & Co., Inc. (1)
Northrop Corp.
Sundstrand Corp. (2)
TRW, Inc. (5)
Trane Company
Universal Leaf Tobacco Co.
Vetco Offshore Industries Inc.
Virginia Chemical Inc.

Washington

The Boeing Company
The Carborundum Company (1)
Dupont (1)
Fenton Int'l., Inc.
John Fluke Mfg. Co.
The Foxboro Company (1)
Ingersoll-Rand Company (1)
Koppers Company
Lockheed Aircraft Corp. (1)
Macmillan, Inc.
PACCAR, Inc.
Sundstrand Corp. (1)
TRW, Inc. (3)
Valley Industries, Inc. (1)
Whitney-Fidalgo Seafoods, Inc. (2)

West Virginia

Dupont (3)
The Foxboro Company (1)
Ingersoll-Rand Company (1)
Koppers Company (1)
McJunkin Corp.
Michigan General Corp. (1)
Monsanto Company (1)
Norris Industries (1)
United Technologies Corp.

Wisconsin

- Albany Int'l. Corp. (3)
- The Ansul Company
- The Black & Decker Mfg. Co. (1)
- Briggs & Stratton Corp. (1)
- Bucyrus-Erie Company
- Congoleum Corp.
- Dupont (1)
- Donaldson Co., Inc. (1)
- Eastern Air Lines, Inc. (1)
- Eaton Corp. (2)
- The Foxboro Company (1)
- Gould Inc. (2)
- Heil Company
- Inland Container Corp. (1)
- Knogo Corp. (1)
- Leesona Corp. (1)
- Manitowoc Co., Inc.
- Merck & Co., Inc. (1)
- Norris Industries (1)
- Northwest Engineering Company
- Oilgear Company
- Oshkosh Truck Corp.
- Portec Inc. (1)
- Rexnord Inc.
- Sola Basic
- Sta-Rite Industries, Inc.
- Sundstrand Corp. (4)
- TRW, Inc.
- Tecumseh Products Co. (2)
- The Toro Company (1)
- Trane Company

Wyoming

- TRW, Inc. (1)

Senator PACKWOOD. I doubt it will come to pass, but I am curious why so many businesses would trade off DISC for a 50-percent reduction in the corporation excise tax if they can have a guarantee of that quid pro quo. Many feel it will go into the social service program and they would still have a 48-percent tax.

I have not asked your particular business, but why are they so willing to make that trade?

Mr. GARFIELD. I am not in favor of it and I can speak for them.

Senator PACKWOOD. In Portland, those who spoke up, I cannot remember what was said; but they were all involved in the export business but they would prefer to have the mobility rather than the DISC provisions.

Mr. GARFIELD. I suppose if you put a man right where he was forced to make a statement of what he thought would be better for his shareholders, DISC after all is a deferral. A 2-percent reduction in the corporate presumably means a complete forgiveness of that tax and I think that is sort of a comparison of an apple with an orange. I think most people would rather, if DISC for example were a forgiveness as opposed to a deferral, it would be enormously more attractive. But the answer may be influenced by considerations such as that.

Mr. SAUEREISEN. Senator, for small businesses at least, we need both. I am real serious. Availability of capital—it is almost nonexistent to comply with requirements. I need not describe that further..

Senator CURTIS. If I may inject there, I don't quite agree with the premise of the question. It is like asking a bachelor whether or not he would rather have the deduction for the support of children increased or have a reduction in his rate of taxation. There are so many more people who would be affected by a reduction in the rates than there are at the present time who have an interest in DISC. It seems to me a rather impossible tradeoff for them to express an opinion on.

Senator PACKWOOD. It is not impossible in terms of money. I am not optimistic this Congress will do much for capital formation. We may make the investment tax credit permanent, which means permanent

until we change it again in 2 or 3 years. If there is going to be any substantial increase in the ability of businesses to have better access to capital formation, it is going to have to be at the expense of something else that business gets. You are not going to get both. I want to make sure business has as much access to capital with as much freedom as possible to invest it as they want. You may not get anything. We may wind up with provisions close to the House provisions. I am feeling around for some rational compromise. I think they are fair comparisons with respect to working capital for business.

I have no other questions.

Senator TALMADGE. Thank you very much, gentlemen, for an impressive presentation.

[The prepared statement of Mr. Garfield follows. Oral testimony continues on p. 1140.]

TESTIMONY OF DAVID C. GARFIELD, CHAIRMAN SPECIAL COMMITTEE FOR U.S. EXPORTS

Mr. Chairman, I am David Garfield, Vice Chairman of Ingersoll-Rand Company, and Chairman of the Special Committee for U.S. Exports. I am appearing today on behalf of the Special Committee, a voluntary group of over 435 business firms whose operations include the export of U.S. products, and who share the conviction that the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code have been instrumental in enabling U.S. businesses to successfully cope with the tax advantages and direct subsidies provided our foreign competitors by their governments. Also supporting the objectives of the Special Committee are 40 business associations. A list of member companies and supporting associations is attached as Appendix A.

The primary objective of the Special Committee for U.S. Exports (hereafter referred to as "the Special Committee") is to support the retention and improvement of the DISC provisions, and to oppose changes which would render the program inoperable or less effective.

Last July, in testimony before the House Ways and Means Committee, we presented the evidence that was then available from private and government sources about the benefits of DISC to our economy in terms of export stimulation and trade balance, domestic employment and positive revenue gains for the Treasury. Even the most conservative extrapolations from available statistics indicated that DISC has been a major positive factor in our improved trade position and in our steady recovery from a damaging recession.

BACKGROUND OF DISC LEGISLATION

The DISC export incentive was first proposed by the Treasury Department as part of the Revenue Act of 1971. The then Secretary of the Treasury urged its adoption on three grounds: (1) to stimulate a reversal in the declining trend of U.S. share of the world's export market, (2) to help achieve long-term trade balance in light of growing U.S. imports of foreign produced commodities, and (3) to provide an alternative to those U.S. firms which found it necessary to invest in foreign based plants and equipment in order to compete effectively in many of the major markets of the world.

The proposal was not intended as a "subsidy" for U.S. producers who could not compete effectively in a free market, nor was it intended to give the U.S. a special trade advantage. There was in addition to the grounds stated in the Treasury Department one simple and compelling justification. Foreign governments had, over a period of many years, granted a variety of tax incentives and direct subsidies to encourage production for exports, and at the same time had imposed a variety of border taxes and non-tariff barriers to discourage competition by U.S. producers and others who sought to sell competitively in their domestic markets.

A powerful U.S. industrial economy was able to absorb these handicaps for many years, but it had clearly reached the point where our economy would suffer serious and irreparable damage if some semblance of equilibrium was not reestablished.

Treasury proposal

The Treasury Department proposed that 100% of qualified DISC earnings would be deferred from federal income taxation for up to 15 years.

House action

In passing its version of the Revenue Act of 1971, the House of Representatives approved an "incremental" approach, which provided that only those export sales in excess of 75% of average sales for a three year base period, 1968-1970, would qualify for deferral. It was thought that concentrating DISC benefits on those firms which increased exports over historic levels would serve better to correct the balance of payments problem.

Senate and conference solution

In its 1971 testimony before your Committee on the bill, the Treasury Department and virtually all public witnesses opposed this "incremental" approach on the grounds that it would penalize those who had worked to develop export markets under adverse conditions, that it would remove a major portion of the incentive to keep existing manufacturing plants in the U.S. unless exports increased above the base period level, and that it would be countercyclical in impact in the sense that there would be little or no incentive for U.S. exporters during times of declining export sales. In addition, the incremental approach was found to pose extraordinary technical problems in administration and compliance.

Because it would obviate the long-term benefits for which DISC was designed and intended, the incremental language was rejected by the Finance Committee and the Senate. Instead, the Senate passed a 50% tax deferral for qualified DISC income, and this solution was adopted in conference and is now the law.

HOW DISC HAS WORKED

Since its first year of effective operation in 1972, the DISC tax deferral provisions have stimulated increases in U.S. exports far beyond the expectations of those who advocated enactment in 1971.

At last report from the Treasury Department, 7,800 DISC elections have been made.

Forty-one percent of all U.S. exports in fiscal year 1973 (the most recent year for which Treasury has figures) were DISC related, amounting to $21.9 billion in gross sales.

After excluding amounts attributed to other factors, such as the floating exchange rate, the Treasury report estimates that $2.56 billion of export increase in the first year of operation of the DISC was directly attributable to the DISC incentive. Based on that experience Treasury concludes that about $5.2 billion in additional exports were attributable to DISC in 1975 adding to the gross national product (GNP) an amount in the range of $10 to $15 billion.

In terms of jobs created by DISC, Treasury and the Bureau of Labor Statistics estimate that approximately 180,000 jobs in 1975 were generated by the export incentive with an additional 600,000 to 900,000 resulting from the secondary impact on GNP. A Commerce Department publication in February of this year pointed out that "recent studies also indicate that the $10 to $15 billion gain in GNP . . . (from DISC in 1975) will generate $2 to $3 billion in Federal taxes. Accordingly, the direct revenue loss by the DISC tax deferrals ($1.3 billion in 1975) is more than offset by the indirect effect of the increased exports on increased GNP revenue gains ($2 to $3 billion indirect revenue gains in 1975)." Thus, under today's circumstances DISC does not lose revenue for the Treasury, on the contrary it is a revenue gainer.

We believe these estimates of the DISC impact are conservative. Independent analysis made in July of last year confirms a highly favorable impact on incre-

mental export volumes, tax revenues and job development (see summary at study by Norman B. Ture, Inc., Economic Consultants, Appendix B).

As a starting point for review of U.S. trade performance for the period immediately prior to and following enactment of DISC, it is useful to examine the following table of exports, imports and net balances for the period 1970–1975.

MERCHANDISE TRADE BALANCE, 1970 TO 1975

[In millions—current dollars]

Date	Exports[1] (excluding military grants)	Import[2]	Net balance
1970	$42,469	−$39,866	$2,603
1971	43,311	−45,579	−2,268
1972	49,388	−55,797	−6,409
1973	71,379	−70,424	955
1974	98,309	−103,586	−5,277
1975	107,250	−98,104	9,146

[1] Exports on f.a.s. (freight alongside ship) basis.
[2] Imports on official customs basis through 1973, on f.a.s basis 1974 and 1975.

There are a number of interesting facets to these figures, and any examination of the contribution of DISC to the nation's economy warrants a look at those components not readily visible in a simple chart of export growth, import values and trade balances.

We are well aware of the arguments of critics that the DISC incentive is no longer needed because of changes in the international monetary structure . . . or that it has benefited only a few exporting companies . . . or that it is a costly drain on the Treasury . . . or that the job producing benefits are offset by the return flow of imported goods . . . or that it has now done its job and we should return to a pure "free market" concept. These and other arguments deserve full discussion and analysis, and it is our purpose in the balance of this statement to contribute in a meaningful way to that dialogue.

DISC PARTICIPATION IS WIDESPREAD

One of the most frequently heard criticisms of DISC is that it favors large companies which have traditionally been involved in export trade, that small businesses have derived little or no benefit, and that it has not served to encourage new entrants into the export market.

Unfortunately, the published Treasury Department reports do not address the question of export volumes by size of DISC participants. We believe it would be useful if future reports required by the Act would be more specific in supplying information which only the Treasury can supply—a composite breakdown of DISC tax returns by size.

In the absence of such published information, however, there is substantial evidence that DISC benefits are widely distributed throughout the economy and the business community.

Over 7,800 DISCs have been formed, with a preponderance of recent formations being small business related;

Even in the first full year of experience—June 1972–June 1973—Treasury analysis indicates that 50% of the companies forming DISCs had assets of less than $10 million; and 14% of these had assets of less than $1 million;

Also during that early period, 49% of the DISCs themselves (as distinguished from parent company operations) had sales of less than $1 million.

It is also noteworthy that, of the membership of the Special Committee listed at the conclusion of this statement, 125 or over 25% are companies with fewer than 1,000 employees.

Since its initial formation, the Special Committee has strongly advocated reform and simplification of the DISC regulations to facilitate participation by smaller businesses. Present requirements are bewilderingly complex, and it is a

credit to the initiative of small businesses throughout the country that so many of them have overcome this built in impediment.

Therefore, we challenge the argument that DISC is only for the large, and we invite critics on that point to join with us in supporting easing the cost and complexity of DISC formation to encourage even greater participation by small and medium sized companies.

LONG-TERM NEED FOR EXPORT INCENTIVES

The economic importance of exports to the U.S. economy has increased rapidly. In 1974 U.S. exports of goods and services amounted to 10% of our total GNP. Three years earlier exports amounted to only 6% GNP.

The oil embargo of 1973, coupled with the quadrupling of oil prices, has signaled the arrival of a new era of scarce high cost energy to which we are still trying to adjust. Over one-third of our imports are essential imports of oil and raw materials which could not be economically supplied domestically. To pay for these imports, U.S. exports must grow at least as fast.

TABLE 3.—DEPENDENCE ON SELECTED IMPORTED INDUSTRIAL RAW MATERIALS, 1973

[Imports as a percent of consumption]

	United States	European Community	Japan
Aluminum	86	60	100
Chromium	91	100	100
Cobalt	96	100	100
Copper	6	96	83
Iron ore	20	59	99
Lead	26	70	70
Manganese	98	99	86
Natural rubber	100	100	100
Nickel	72	100	100
Phosphates	(1)	100	100
Tin	87	99	93
Tungsten	68	100	100
Zinc	63	60	68

Source: International Report of the President—March 1975.

As noted earlier in our statement, DISC was not proposed in 1971 as a short-term remedy for a temporary problem. It was intended instead as a long-term incentive to assist American businesses in coping with the many direct and indirect subsidies that were deeply imbedded in the laws of foreign countries for the purpose of encouraging their domestic production for export markets.

To understand the significance of this in terms of its impact on the U.S. economy, it must be viewed in a multilateral as well as bilateral sense. In other words, we cannot be content with merely analyzing a country's export incentives and import barriers in terms of our trade balance with that country alone. We are also in direct competition with its exports in the marketing of identical or similar commodities to all the other countries of the world.

In this perspective, the long range problem is evident. Although total international commerce is expanding, the U.S. share of world exports has been in long-term decline.

One of the important reasons for this decline is readily apparent for a study of foreign country export incentives. (For detail discussion, see Appendix C.)*

By far the most graphic illustration of the large number and variety of measures which have been adopted by other countries over the years is to be found in the charts comprising Appendix D to this statement. Even a cursory look will demonstrate why the subject does not lend itself to easy summation. Some countries have only a few, but very substantial, incentives. Others have spread the export incentive impact over a dozen or more separate provisions in their tax and trade laws and regulations. Expert examination clearly shows, however, that

*Appendix C was made a part of the official files of the committee.

the U.S. is ranked at the bottom among the major industrialized nations in terms of government encouragement for export marketing.

We readily join with some of the critics of DISC in wishing that these conditions did not exist. But they do exist. The number of programs adopted by other governments is increasing both in number and in relative value. There are no signs that conditions are going to change in the near future.

International trade is not conducted in the same environment that we often hear described by theorists. Nor does business flow automatically to those who espouse the principles of "free trade." In the real world, such business is dependent upon specialized and expensive trade promotion, technological parity or superiority, overall quality of product, and price.

Vital to all of these components is the element of stability in government policies. DISC has been in operation only a short time, and the period for which data is available for evaluation is even more limited. But we know that investments have been made by participating companies to comply with the strict provisions of the Act. Commitments of personnel and other resources have been made to export promotion programs. Production goals and manufacturing labor forces have been expanded in anticipation of continuing DISC benefits. Decisions on plant expansions and locations have been made. Such actions and decisions are precisely what the Congress intended when DISC was first enacted.

But now, after such a short time, there are the combined threats of damaging amendments or outright repeal. Secretary Simon said it well recently when he testified before the Joint Economic Committee that such "stop-and-go policies . . . create a climate of great uncertainty for business planning." There seems to be widespread understanding of the need for a stable tax policy regarding another major tax incentive, the investment tax credit. It is equally great in the case of the DISC.

HOW DISC IS VIEWED BY OTHERS

Another common complaint of critics is that DISC is not effective as an export incentive and that it simply rewards those who would be exporting anyway. If this were so, then there would be no cause for complaint from other nations about its impact on competitive relationships. But indeed there are such complaints. One is now pending before the General Agreement on Tariffs and Trade (GATT), and hearings were held this month.

It is significant that one of the principal complainants was Canada. And for what reason? The Canadian representative argued that the DISC tax incentive has encouraged U.S. business to manufacture products in U.S. plants for export to Canada instead of building the plants in Canada and thus using Canadian labor.

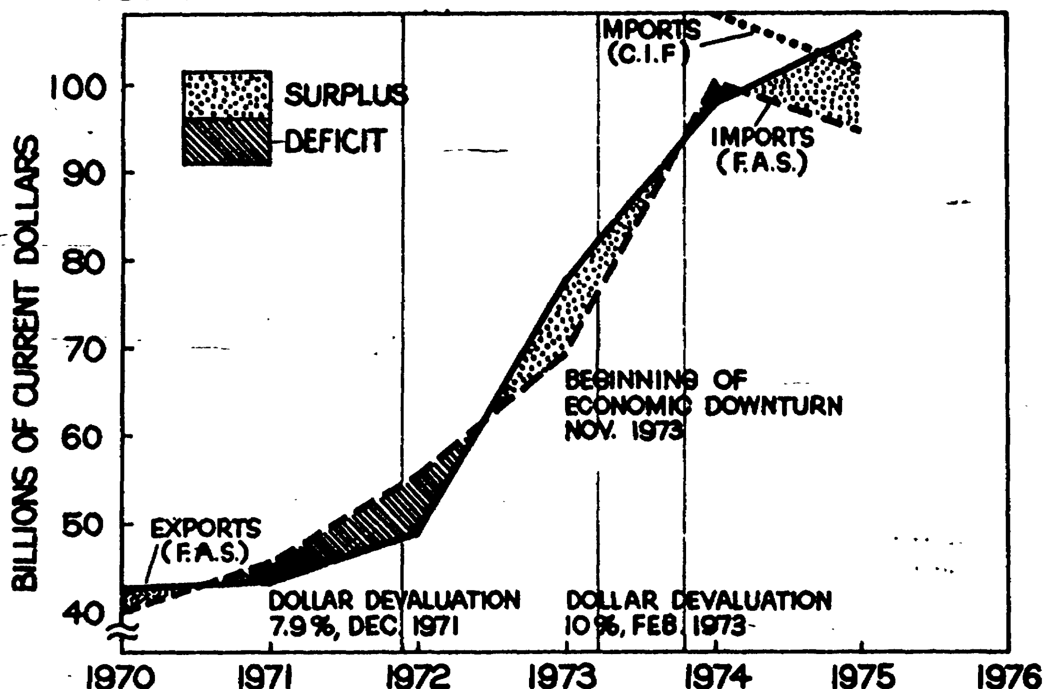
If evidence is needed beyond what has already been provided that DISC is fulfilling its intended function, the GATT proceedings should suffice.

Admittedly, there are some who oppose DISC because they feel it is not an eligible practice under GATT, but critics cannot have it both ways. They cannot condemn it for giving the U.S. an unfair advantage and at the same time condemn it as being ineffective.

CURRENT WORLD ECONOMIC CONDITIONS

There is every indication that DISC export incentives are needed now and will be needed in the future even more than in the past several years. The contribution of DISC to U.S. economic recovery is evident in the results of Treasury and Commerce Department analyses. We readily concede, however, that the extraordinary U.S. trade surplus in 1975 was more the result of reduced U.S. demand for imports than it was the result of increased exports. It is to the credit of DISC and the effotrs of participating companies that U.S. exports increased so substantially during the period 1972–1975 over what would otherwise have been anticipated from the effects of dollar devaluation alone.

The following chart demonstrates the correlation between export-import activities and such economic events as the devaluations of the dollar and the beginning of the U.S. economic downturn in late 1973. (Although not indicated graphically on the chart, it should be noted that the level of U.S. exports was rising slightly prior to the first devaluation. The second devaluation—which was even larger in magnitude—had little discernible effect on export or import trends.)



In any event current conditions indicate a completely new set of circumstances. The dollar has now strengthened substantially in relation to other major currencies, due in large measure to a strong foreign trade position throughout the recent period of worldwide recession. Partly as a result of this trade position, the United States is recovering much more rapidly from the downturn than most of our trading partners. As America's purchasing power increases in relation to other countries, they will look more to our market to hasten their own recovery. Recent devaluation of the franc, the lira and the pound is consistent with and may encourage that natural economic process.

EXCHANGE RATES[1]

	Trade, weighted dollar	L	FFr	DM	Lira	DFl	BFr
March 1971	−3.04	2.4187	5.5160	3.6312	622.55	3.5951	49.64
March 1972	−10.33	2.6181	5.0416	3.1701	582.72	3.1863	43.94
March 1973	−14.04	2.4724	4.5063	2.8113	568.05	2.9126	39.40
March 1974	−14.67	2.3406	4.8211	26.170	637.47	2.7507	38.93
March 1975	−18.48	2.4180	4,2010	23.191	631.23	2.3739	34.38
March 25, 1976	−12.73	1.9240	4.6926	25.458	839.63	2.6903	38.92

[1] Trade weighted dollar figures show percent change from May 1970 value and are stated as the average of daily rates during the calendar quarter. Nondollar exchange rates are stated as of last day of calendar quarter.

Source: Morgan Guaranty Trust Co., New York.

This, combined with expected increases in U.S. imports of oil and raw materials for a fast-recovering manufacturing sector, can quickly throw our trade balance into major deficit again.

The long-term record has not been good. The U.S. "current account deficit" for the period 1968–1973 was $17 Billion. Over the longer period 1960–1973 it was a staggering $60 Billion. Trade figures for January 1976 show signs that trade deficits are not a thing of the past, but could threaten again after only one year of relief.

When viewed in the context of the long-term record and current conditions, last year's $9.1 Billion surplus gives no reason for complacency. In order to maintain stability of the dollar, to maintain our purchasing power for needed foreign products, and to achieve new job opportunity levels, the U.S. must place greater emphasis than ever on stimulating its exports.

ARE TRADE SURPLUSES SELF-DEFEATING?

That brings us to one of the most baffling of the claims of DISC critics. Some of them are saying that trade surpluses are self-defeating in that they result in appreciation of the dollar in relation to the currencies of those countries suffering trade deficits. As a result, they say, our products become more expensive, theirs become cheaper, and equilibrium is quickly restored.

As with most economic hypotheses, there is an element of truth in their argument.

If the floating exchange rate system worked freely and without government manipulation * * * if every country had a true free-market economy * * * if every border were equal in terms of product access and egress * * * and if purchases of essential energy and raw materials could be turned on and off as if they were optional "luxuries" * * * then maybe the hypotheses could be translated into reality.

The facts are that none of these circumstances prevail universally throughout the major world markets, nor are they likely to come about in the foreseeable future. And while it is not likely that the U.S. could or would want to sustain constant trade surpluses, it is possible that, without wise government policies, we could sustain constant deficits.

If DISC critics are suggesting that the U.S. should make the altruistic sacrifice of incurring new and sustained trade deficits as an example to the rest of the world, they should be aware that no one would be more disturbed at the prospect than the very people they would be trying to impress, because Europe and Japan, among others, are counting heavily on U.S. vitality and a stable dollar to hasten their own economic recoveries.

OTHER FACTORS IN THE TRADE EQUATION

The DISC incentive cannot be considered in a vacuum. Just as it would be a mistake for its supporters to claim it as a panacea for all foreign trade problems, it is also a mistake for its opponents to view it without regard to the longer issues that are important to our economic future.

Some of these longer issues have already been touched upon—employment, tax revenues, stability of the dollar, etc. But there are others just as important over the long-term but unfortunately not so visible to the eyes of today.

A recent study submitted to Congress by the National Science Foundation contains the disturbing conclusion that U.S. leadership in technology is fast slipping away. One startling revelation is that 30% of the patents now being granted by the U.S. are granted to foreign individuals and companies. One of the principal causes, according to the NSF study, is the decline in U.S. expenditures for research and development.

We would offer a number of reasons for the trend—including that of government mandated investments and expenditures which reduce the amount of available earnings for private research and development—but that is a topic for another time and place.

It is a fact that, as real corporate earnings decline, R&D expenditures suffer to a larger extent than expenditures which are more "immediate" in nature. And real corporate profits have been in decline. As the capital markets—both for equity and for borrowing—become tighter, research and development into new and innovative products becomes more "costly" in relation to other needed investments. And the capital markets have been tight.

The role of exports in stimulating improved U.S. technology is a substantial one. Approximately 60% of U.S. exports fall into the category of "high technology." Income from export sales help support ongoing research and development to improve those products and to bring new products onto the market (over $130 billion was expended over the period 1969–1974). The benefits to U.S. consumers are two-fold. Our economy is generally first to incorporate the new technology, and the high initial R&D costs are amortized over both domestic and export markets, resulting in greater economies.

In many cases, the investment of retained DISC earnings in the export-related activities prescribed by law frees up other corporate funds for research and development purposes.

The U.S. must reverse the trend indicated by the NSF report and other reliable sources over the past several years. The emphasis and incentive provided by DISC can be an important factor in turning the situation around.

CAPITAL SHORTAGES

As is the case with the Investment Tax Credit and other tax provisions now being reviewed by your Committee, the DISC incentive is also a vehicle for improved capital savings, and to that extent can continue to aid in overcoming the capital shortages predicted to occur over the next ten years.

HOUSE-PASSED DISC AMENDMENTS

As it did in its initial consideration of DISC in 1971, the House of Representatives, in H.R. 10612, has settled on the so-called "incremental" approach which was rejected by the Senate at the time of original enactment.

Only this time the House version is worse than in 1971. DISC treatment would apply to 75% of the company's export income in excess of the average over an initial three-year base period of 1972–1974. But after five years, it becomes a "rolling" base. The first year of the base period is dropped and the next succeeding year is added. The rolling base period magnifies all of the problems which were pointed out by Treasury and public witnesses in testimony before your Committee in 1971.

The most significant problem will be the effect of a moving base on cyclical movements in exports sales. Over a period of years, exports may rise on the average. However, economically there will be upswings and downswings in such sales over a period of years. The incremental approach with a moving base will result in little or no DISC benefits during a downswing when incentives are needed.

The moving base would also increase the discrimination between taxpayers resulting from the adoption of the incremental approach. Unusual business conditions over a period of years will, in all likelihood, create even greater disparity between taxpayers than a fixed base.

Finally, the moving base would result in even more market disruption due to the additional planning factors necessarily involved and administrative and compliance problems would be substantially increased. A brief historical summary of the "incremental" approach and further comments is attached as Appendix E.

AGRICULTURAL EXCLUSION

The House Bill also specifically excluded certain agricultural products from DISC, on the ground that the incentive was no longer needed due to high demand abroad. A 50% value-added from manufacturing test was applied, and only agricultural products meeting the 50% test would continue to qualify for DISC treatment.

There is no reason to discriminate against the agricultural sector of our economy in relation to the industrial sector. Agricultural commodities are not in short supply. In fact, if a particular commodity becomes in short supply, the existing DISC provisions provide for its removal from DISC treatment.

Agriculture is one of the largest sources of U.S. exports and a major contributor to the U.S. balance of payments. In view of the current world food shortage, U.S. agriculture and agricultural exports should be provided with every encouragement to expand.

Agricultural commodities are the primary U.S. export resource which can be used to offset the exorbitant price levels established by international bodies controlling the price of raw materials such as oil. It is essential that our agricultural productivity continue to grow to offset this growing international trend.

The expansion of agriculture not only increases the income of farmers and the number of jobs in agriculture, it also creates numerous other benefits to the economy. For example, the farm machinery and agricultural chemical industries will add to their plan and equipment and labor force.

The expansion of agricultural exports also serves to reduce the cost of U.S. government price supports. At the same time, the expansion and modernization of

agricultural facilities due to world demand will create more efficient production of agricultural commodities and reduce the cost to domestic consumers.

Finally, many commodities are subject to strong foreign competition in foreign markets. In other cases, there is competition from abroad with respect to whether the commodity is processed in the U.S. or abroad.

A brief historical summary of the agricultural exclusion and further comments is attached as Appendix F.

EXCLUSION OF MILITARY SALES

The sale of military products is a significant factor to the U.S. economy and U.S. employment. The same economic and employment benefits are derived from the export of military hardware as those derived from the export of any other U.S. produced goods. We feel the action of the House to exclude such sales from DISC treatment was unduly discriminating and a mistake.

Sales of military products, whether on a government-to-government basis or on the basis of sales between a company and a foreign government, are extremely competitive. Other industrial nations strongly encourage sales of military products by their manufacturers and provide major competition to U.S. companies. Even though the U.S. government may be an intermediary on the sale of a military product, the U.S. company is required to expend considerable time and funds in obtaining the final contract. Thus, military sales are subject to severe competition equal to or greater than other U.S. exports and should not be singled out for separate treatment.

Finally, any decision with respect to the merits of sales of military products involves consideration of the Foreign Military Sales Act. The tax code is not the proper place to legislate on the merits of military sales.

A brief historical summary of the military sales exclusion and further comments is attached as Appendix G.

EXTENT OF LOSS OF DISC BENEFITS

The House Bill, if enacted, would represent a serious blow to U.S. exporters. The loss of DISC benefits would exceed 60% of those contained in the present law. The agricultural and military sales exclusions alone would reduce the benefit of DISC by about 20%. The incremental approach of the House Bill would reduce the benefit of the remaining 80% by about one half—resulting in a total loss of about 60% (20% plus 40%).

RECOMMENDATIONS OF THE SPECIAL COMMITTEE FOR U.S. EXPORTS

The membership of the Special Committee and those associations which have joined in formulating and supporting its objectives recommend that the House amendments to the Domestic International Sales Corporation provisions of the Internal Revenue Code be rejected in their entirety.

Specifically, the Special Committee recommends:

1. That the existing provisions remain in effect as a permanent feature of the Internal Revenue Code; and in the long run they should be expanded to 100% deferral as originally proposed by the Treasury in 1970.

2. That no exclusions be provided other than those already in the law for purposes of ensuring adequate domestic supplies of certain commodities; and

3. That consideration be given to simplification of procedures for establishing and operating a DISC subsidiary so that additional small and medium sized businesses will be encouraged to participate and to assist in meeting national export goals.

CONCLUSION

In conclusion, the Special Committee for U.S. Exports believes the principal reasons for opposition to DISC from some quarters in and out of the Congress is the failure of business, labor and supporting agencies of government to adequately explain its reason for being, its effectiveness of operation, and its demonstrated benefits for achieving certain public policy objectives.

We hope the information we have provided in this statement and additional information which will be furnished as it becomes available will serve to bring about a more accurate view of the role of the Domestic International Sales Corporation provisions, its cost effectiveness, its job-creating record and potential for the future, and its revenue-producing benefits.

APPENDIX A

SPECIAL COMMITTEE FOR U. S. EXPORTS

Supporting Companies

A-T-O Inc.
Acker Drill Company, Inc.
Acme-Cleveland Corporation
Addison-Wesley Publishing Company
Ag-Met, Inc.
Air Prodicts and Chemicals, Inc.
Ajax Magnethermic Corp.
Akzona, Inc.
Albany International Corp.
Alcon Laboratories, Inc.
Allegheny Ludlum Industries, Inc.
Allied Chemical Corporation
Alvey Inc.
American Can Company
American Export Lines, Inc.
American Hoist & Derrick Company
American Hospital Supply Corp.
American Medicorp Inc.
American Microsystems, Inc.
American Precision Industries Inc.
American Telecommunications Corp.
Anaconda Company
Analog Devices, Inc.
Anchor Hocking Corporation
Anderson Greenwood & Co.
The Ansul Company
Apache Corp.
Armco Steel Corporation
Aro Corp.
Ashland Oil, Inc.
Aspro, Inc.
Astrosystems, Inc.
Atlantic Richfield Company
Augat Inc.
Avnet, Inc.
Babcock Industries, Inc.
Baker International Corporation
The Bank of New York
Bandag Incorporated
C. R. Bard, Inc.
The Bates Manufacturing Company
Bausch & Lomb
Beckman Instruments, Inc.
Beech Aircraft Corporation
Beker Industries Corp.
Belmont Industries, Inc.
The Bendix Corporation
Bentley Laboratories, Inc.
Bertea Corporation

The Black & Decker Mfg. Co.
Bliss & Laughlin Industries, Inc.
The Boeing Company
Bohemia Inc.
Borden Inc.
Born Export Corporation
Bowen Tools, Inc.
Braden Industries, Inc.
Briggs & Stratton Corporation
Brooks and Perkins, Inc.
Buckman Laboratories, Inc.
Bucyrus-Erie Company
The Budd Company
Bunge Corporation
Calbiochem
The Carborundum Company
Carpenter Technology Corporation
Carrier Corporation
Celanese Corporation
Centronics Data Computer Corp.
Cessna Aircraft Co.
Chemetron Corporation
The Chesapeake Corporation of Virginia
Chicago Bridge & Iron Company
Chicago Pneumatic Tool Co.
Chromalloy American Corporation
Cincinnati Milacron Inc.
Clark Equipment Company
Classic Chemicals Company
Cluett, Peabody and Company, Inc.
Cobe Laboratories, Inc.
Coherent Radiation
Colt Industries Inc
Columbine International Corp.
Columbus McKinnon Corp.
Comdisco, Inc.
Commercial Shearing, Inc.
Condec Corporation
Cone Mills Corporation
Congoleum Corp.
Consyne Corporation
Container Corp. of America
Continental Grain Company
Conwood Corporation
Cook Industries, Inc.
Copeland Corporation
Copperweld Corporation
Corenco Corp.
Corning Glass Works
Craig Corporation
Crompton & Knowles Corporation
Crocker National Bank
The Cross Company
A. T. Cross Company

Crouse-Hinds Company
Cyprus Mines Corp.
Daniel Industries, Inc.
Data Card Corporation
Datapoint Corp.
Dataproducts Corp.
Datascope Corporation
Dayco Corporation
Deere & Company
Delta & Pine Land Company
Den-Tal-Ez, Inc.
Dennison Mfg. Co.
Dentsply International
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Digital Equipment Corporation
Donaldson Company, Inc.
Dow Chemical Company
Dreis & Krump Manufacturing Co.
Dresser Industries, Inc.
Louis Dreyfus Corp.
W. B. Dunavant & Co.
E. I. duPont deNemours & Company
The Duriron Company Inc.
ESB Incorporated
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Eastern Air Lines Inc.
Eastman Kodak Company
Eaton Corporation
Eberline Instrument Corporation
Echlin Mfg. Co.
Egan Machinery Co.
Electro-Craft Corporation
Elgin National Industries, Inc.
Emerson Electric Company
Emery Industries, Inc.
Envirotech
Esmark, Inc.
Ethyl Corporation
The Eversman Mfg. Company
Extracorporeal Medical Specialties Inc.
FMC Corporation
Farah Mfg. Co., Inc.
Federal-Mogul
Federal Paper Board Company, Inc.
Fenton International, Inc.
Fibreboard Corporation
Fischer & Porter Company
Fisher Scientific Co.
Flowers Industries, Inc.
John Fluke Mfg. Co.
Flying Tiger Line, Inc.

Foster Wheeler Corp.
The Foxboro Company
Franklin Electric Co., Inc.
H. B. Fuller Company
GAF Corporation
Galaxy Carpet Mills, Inc.
Galveston-Houston Company
Gardner-Denver Company
Garlock, Inc.
The Garrett Corporation
General Cable Corporation
General Dynamics Corp.
General Electric Company
General Host Corp.
General Mills, Inc.
General Telephone & Electronics Corporation
Geon Industries, Inc.
Georgia-Pacific Corporation
Gilford Instrument Laboratories, Inc.
Sylvan Ginsbury Ltd.
Glasrock Products, Inc.
Gleason Works
Globus Corporation
Gloucester Engineering Co., Inc.
Gorman-Rupp Co.
Gould Inc.
Graniteville Co.
Great Lakes Chemical Corporation
Grotnes Machine Works, Inc.
Grove Mfg. Co.
Grumman Corporation
Guardian Packaging Corp.
Hach Chemical Co.
Hammermill Paper Co.
Hankison Corporation
Harper & Row, Publishers, Inc.
Harris Corp.
Harris Trust and Savings Bank
Heil Co.
Henningsen Foods, Inc.
Hercules Incorporated
Hesston Corporation
Hobart Corporation
Hoffman Electronics Corporation
Honeywell Inc.
Hooker Chemicals & Plastics Corporation
Hoover Ball & Bearing Co.
Horix Mfg. Co.
Hughes Tool Co.
Hy-Gain Electronics Corp.
Illinois Tool Works Inc.
ICA Export Co., Inc.
Incoterm Corporation
Indian Head Inc.

APPENDIX A

The Ingersoll Milling Machine Company
Ingersoll-Rand Company
Inland International, Inc.
Instrumentation Laboratory, Inc.
Instrumentation Specialties Company, Ltd.
The International Flavors & Fragrances, Inc.
International Harvester Company
International Paper Company
International Telephone and Telegraph Corporation
Richard D. Irwin, Inc.
Jacuzzi Bros., Inc.
Johns-Manville Corporation
Joy Mfg. Co.
Kearney-National Inc.
Kendavis Industries Int'l. Inc.
Kennametal Inc.
Kewanee Industries, Inc.
Keystone Consolidated Industries Inc.
Kirsch Co.
Knogo Corp.
Kollmorgen Corp.
Koppers Company
Kuhlman Corp.
The LTV Corporation
La Pointe Industries, Inc.
W. D. Lawson & Company
Lear Siegler, Inc.
Lee Pharmaceuticals
Leesona Corporation
Levi Strauss & Co.
Libby, McNeill & Libby
Eli Lilly and Company
Lincoln First Banks Inc.
The Lockformer Company
Lockheed Aircraft Corp.
Lord Corp.
Louisiana-Pacific Corporation
Ludlow Corp.
Ludlow Industries, Inc.
Lukens Steel Company
Lummus Industries, Inc.
Macmillan, Inc.
Magnetic Controls Company
Manitowoc Co., Inc.
Marathon Mfg. Co.
Marine Colloids International Inc.
Marion Power Shovel Company, Inc.
Marsh Stencil Machine Co.
Martin-Marietta Corporation
Massey-Ferguson Inc.
McCord Corp.
McDonnell Douglas Corporation
McGraw-Edison Co.
McJunkin Corp.

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Mead Corp.
Measurex Corp.
MEM Company, Inc.
Merck & Co., Inc.
Michigan General Corporation
Michigan Seamless Tube Co.
Midland-Ross Corp.
Mine Safety Appliances Company
Modern Industrial Engineering Co.
The Mogul Corporation
The Monarch Machine Tool Company
Monsanto Company
Moog Inc.
Moore Special Tool Co.
Morgan Construction Company
Motorola, Inc.
NL Industries, Inc.
Napco Industries, Inc.
Narco Scientific Industries, Inc.
National Distillers and Chemical Corporation
National Forge Company
Newpark Resources, Inc.
Norris Industries
North American Philips Corporation
Northern Natural Gas Co.
Northrop Corp.
Northrup, King & Co.
Northwest Airlines, Inc.
Northwest Engineering Company
Oak Industries Inc.
Oilgear Co.
Olin Corp.
Oshkosh Truck Corp.
PVO International, Inc.
PACCAR, Inc.
Pacific Lumber Co.
Pan American Trade Development Corp.
The Ralph M. Parsons Co.
Peabody-Galion Corp.
Peachtree Doors, Inc.
Peavey Company
Pertec Corp.
Piper Aircraft Corp.
Pneumo Corp.
Pope & Talbot, Inc.
Portec Inc.
Porter Paint Co.
Possis Corp.
Prentice-Hall, Inc.
Production Machinery Corporation
Pugh and Company
RCA Corp.
RayGo, Inc.
Reed Tool Company

Refrigerating Specialties Company
Reichhold Chemicals, Inc.
Reliance Electric Company
Remington Arms Co., Inc.
Republic Steel Corporation
Rexnord Inc.
Riviana Foods Inc.
H. H. Robertson Co.
Rockwell International
Rogers Corporation
Rohm & Haas Company
Rohr Industries, Inc.
Roper Corporation
Rosemount, Inc.
Rucker Company
San Fernando Electric Manufacturing Company
Sauereisen Cements Company
A. Schulman, Inc.
Scientific-Atlanta, Inc.
Seagrave Corporation
Seald-Sweet International
Sealed Power Corp.
Seatrain Lines, Inc.
Sier Bath Gear Co., Inc.
Signode Corp.
The Singer Company
Skil Corp.
Sola Basic
Sonoco Products Co.
Soundesign Corporation
Southern Aluminum Castings Company
Southern Industries Corp.
Southwest Forest Industries, Inc.
Spang & Company
Spang Industries, Inc.
Spectra-Physics, Inc.
Sperry Rand Corporation
Sta-Rite Industries, Inc.
Standard Oil Company of California
Stanray Corporation
Stauffer Chemical Company
Steelmet, Inc.
Sterling Drug Inc.
Jacob Stern & Sons, Inc.
J. P. Stevens & Co., Inc.
Stewart-Warner Corp.
Sugardale Foods, Inc.
Sun Chemical Corporation
Sunair Electronics, Inc.
Sundstrand Corp.
Supreme Equipment & Systems Corp.
Sweco, Inc.
Sycor, Inc.
Systron-Donner Corporation

TRW, Inc.
Tab Prducts Co.
Tappan Company
Starke Taylor & Son, Inc.
Tecumseh Products Co.
Texas Eastern Transmission Corp.
Thermo Electron Corporation
Tiffany Industries, Inc.
Tonka Corp.
Toro Co.
Trane Co.
Tyrone Hydraulics, Inc.
Union Camp Corp.
Union Carbide Corporation
Union Oil Company of California
Union Special Corp.
Union First National Bank of Washington
Uniroyal, Inc.
United Industrial Corp.
United States Filter Corp.
U. S. Industries, Inc.
United Technologies Corporation
Universal Leaf Tobacco Co.
Universal Oil Products Co.
Upjohn Company
VSI Corporation
Valeron Corp.
Valley Industries, Inc.
Valleylab, Inc.
T. K. Valve Manufacturing, Inc.
Van Dorn Co.
Van Dusen Air Inc.
Varian Associates
Vesuvius Crucible Company
Vetco Offshore Industries Inc.
Victor Comptometer Corporation
Virginia Chemicals Inc.
Wachovia Bank & Trust Company, N.A.
Wallace-Murray Corp.
The Warner & Swasey Company
Watkins-Johnson Company
Waverly Press, Inc.
Wean United Inc.
Weatherhead Company
Weld Tooling Corporation
Western Bancorporation
Western Gear Corp.
Westinghouse Electric Corporation
Wheelabrator-Frye Inc.
White Motor Corp.
Whitehall Electronics Corp.
Whitney-Fidalgo Seafoods, Inc.
Williams Companies
Windsor Industries Inc.

Wolff Manufacturing Company
Wolverine World Wide Inc.
Wyman-Gordon Co.
Wynn's Int'l., Inc.
Zurn Industries, Inc.

Supporting Associations

Aerospace Industries Association
Air-Conditioning and Refrigeration Institute
Air Transport Association of America
American Association of Port Authorities
American Farm Bureau Federation
American Paper Institute
American Polled Hereford Assn.
American Quarter Horse Assn.
American Seed Trade Assn.
The Brown Swiss Cattle Breeders Assn.
Electronic Industries Assn.
Emergency Committee for American Trade
Florida Department of Citrus
Great Plains Wheat, Inc.
Holstein-Friesian Assn. of America
International Business-Government Counsellors, Inc.
International Economic Policy Assn.
International Executives Assn.
International Tax Institute, Inc.
I. S. Joseph Company, Inc.
Leaf Tobacco Exporters Assn.
National Association of Manufacturers
National Association of Wheat Growers
National Potato Council
National Soybean Processors Assn.
Potato Board
Poultry & Egg Institute of America
Overseas Automotive Club, Inc.
National Assn. of Wheat Growers
National Cotton Council of America
National Grange
Rice Millers Association
Scientific Apparatus Makers Assn.
J. R. Simplot Company
Tobacco Associates, Inc.
United Fresh Fruit & Vegetables Assn.
United States-Mexico Chamber of Commerce
Western Wheat Associates
World Trade Assn. of Philadelphia, Inc.
Writing Instrument Manufacturers Assn., Inc.

APPENDIX B

NORMAN B. TURE, INC.
ECONOMIC CONSULTANTS
1100 CONNECTICUT AVENUE, N.W.
WASHINGTON, D. C. 20036
(202) 223-6316

NORMAN B. TURE
PRESIDENT

September 17, 1975

To: David Garfield, Chairman
Special Committee for U.S. Exports

Subject: Revisions of August 18, 1975, memorandum on the Economic Effects of DISC

The derivation of the quantitative estimates of the economic effects of DISC, summarized in our July 10, 1975 memorandum is described in detail in our August 18, 1975 memo. Upon close review of the latter, we have identified a number of technical details requiring revision:

o Our initial estimates of the labor and capital coefficients in the production functions were derived from national income rather than gross national product data. Since the basic framework of the analysis depends upon estimating the relationship of changes in GNP, not national income, to changes in exports, the production functions should be estimated in terms of gross product and gross returns to capital. Reestimation of the production function coefficients on this basis raises the capital and reduces the labor coefficients and slightly decreases the intermediate input coefficient. The respective changes are:

Coefficient	Initial estimate	Revised estimate
Labor	.83	.73
Capital	.17	.27
Intermediate input	.70	.67

Mr. David Garfield
September 17, 1975
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o Our initial estimates assumed an elasticity of demand for exports of 5, across the board. In the case of U.S. agricultural exports, virtually undifferentiated from agricultural products supplied by other participants in the world market, this is clearly far too low. While the appropriate elasticity is probably very close to infinity, we have deliberately sought to err on the conservative side and assigned it a value of 10.

o In obtaining our initial estimates, we did not attempt to estimate a production relationship for agricultural products as intermediate inputs to agricultural exports, but assigned thereto the overall business sector labor and capital coefficients. In view of the marked disparity between agriculture and most of the rest of the business sector in the respective coefficients, as indicated in national income account data on factor shares, this procedure resulted in a substantial underestimate of the impact of the DISC provisions on agricultural output. We have revised the estimates for this sector by estimating a separate production relationship for agriculture. It was also assumed that two-thirds of agricultural output as intermediate products originates in agriculture itself, while one-third originates in industries supplying intermediate products, e.g., fertilizers, to agriculture.

o Our initial estimates erred in assuming that the effect of the DISC provisions is to reduce the marginal tax rate on net income attributable to exports to 24 percent. This resulted in an estimated 32 percent reduction in the cost of capital to the DISCs. In fact, the DISC provisions reduce the marginal tax rate to 36 percent, resulting in an 18 3/4 percent reduction in the cost of capital to DISCs.

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Mr. David Garfield
September 17, 1975
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The first three of these revisions increase the estimates of the expansionary impact of the DISC provisions on GNP, employment, capital outlays, and Federal revenues. The third revision reduces these effects. On balance, the revisions result in a substantial increase in expansionary effects. These are summarized in the attached table.

The initial estimate of net revenue effect, as shown in the attached table, reflects an arithmetic error and should have been substantially greater than shown. The revised estimate is only slightly different from the correctly computed initial estimate.

These revisions are incorporated in the revision of the August 18, 1975, memorandum, enclosed herewith.

Revised: September 17, 1975

Summary of Economic Effects of DISC: All Export Industries
(dollar amounts in billions of 1974 dollars)

Increases in:	Initial Estimates	Revised Estimates
1) Employment, total (thousands of man years)	442	365
Export industries	50	71
Supplying industries	392	294
2) Employee compensation, total	4.4	4.1
Export industries	0.6	.7
Supplying industries	3.8	3.4
3) Business sector Gross National Product, total	28.5	29.7
Export industries	14.2	11.5
Supplying industries	14.3	18.2
4) Value of Exports	5.2	6.3
5) Capital outlays due to DISC	22.3	22.8
6) Net Change in Federal tax revenues	1.2	7.9
"Initial Impact" (Treasury estimate)	-1.0	-1.0
Increase attributable to increase in output and income	2.2	8.9

APPENDIX B

NORMAN B. TURE, INC.
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NORMAN B. TURE
PRESIDENT

July 10, 1975

To: William K. Condrell, Esq.

Subject: Economic Effects of DISC

The initial impact of the DISC provisions is to reduce the cost of capital committed to the production and selling of export goods. Business response to this decrease in capital costs is to expand the volume of real capital used for production for export sales; this entails an increase in capital outlays in order to increase the net stock of capital used for this production. The increase in such outlays, hence in the net stock of capital, proceeds to the point at which the after-tax return on this capital is the same (adjusted for difference in risk) as that generally prevailing in the business sector.

Unless it were assumed, contrary to fact, that the elasticity of demand for U.S. exports in world markets is very low, the reduction in the cost of capital attributable to DISC provisions results in an increase in the total physical volume of export goods which U.S. businesses will want to sell at prevailing world prices for these exports. Associated with this increase in production for exports there is an increase in employment as well as in capital inputs in companies engaged in export production and sales.

The increase in export production and sales also requires an increase in production of intermediate products, for which additional capital and labor

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July 10, 1975
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are required. The overall effect of DISC, therefore, is to expand the net stock of capital, capital outlays, and employment throughout the business sector.

The magnitude of the effects on export production, export sales, intermediate goods production, employment, and capital outlays depends on (1) the technical conditions of production in the major export industries and in the total business sector, (2) the ratio of value added in export production to the value of intermediate goods, (3) the conditions of supply of labor services and of capital in the export industries and in the business sector as a whole, and (4) the conditions of demand for U.S. exports in world markets.

On the basis of estimates of these relationships and conditions, it is estimated that total U.S. merchandise exports in 1974 were $5.2 billion greater than they would have been in the absence of the DISC provision.

Employment in production for exports is estimated as 50,000 greater than otherwise in 1974. Additional jobs in the production of intermediate products were about 392,000 in that year. Throughout the business sector, there were 442,000 more full-time equivalent jobs than there could have been in the absence of the DISC.

Wages and salaries paid to employees in export production in 1974 were $0.6 billion greater than the amount that would otherwise have been paid. Adding the $3.8 billion of wages and salaries paid to the additional employees

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July 10, 1975
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in supplying industries, the aggregate amount of employee compensation in excess of the amount which would have been paid in the absence of DISC is about $4.4 billion.

The additional GNP originating in export industries in 1974 is estimated at $14.2 billion. Virtually the same amount --- $14.3 billion --- of additional GNP was generated in supplying industries. The total increment of GNP in the business sector attributable to DISC was $28.5 billion.

Aggregate capital outlays throughout the business sector are estimated to have been $23.3 billion more than they would have been without DISC.

On the basis of the Treasury's fiscal year estimates, the calendar year 1974 revenue loss attributable to DISC is estimated at about $1.0 billion. This is the "initial impact" revenue loss, based on the assumption that there were no changes in exports, production, employment, and income in response to the DISC provisions. These responses, as estimated above, generated about $2.2 billion in Federal tax revenues above amounts of revenues that otherwise would have been obtained. The net revenue effect, therefore, is a gain of about $1.2 billion.

William F. Condre. Esq.
July 10, 1975
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Summary of Economic Effects of DISC: All Export Industries
(dollar amounts in billions of 1974 dollars)

Increases in:

1)	Employment, total (thousands of man years)	442
	Export industries	50
	Supplying industries	392
2)	Employee compensation, total	4.4
	Export industries	0.6
	Supplying industries	3.8
3)	Business sector Gross National Product, total	28.5
	Export industries	14.2
	Supplying industries	14.3
4)	Value of Exports	5.2
5)	Capital outlays due to DISC	22.3
6)	Net Change in Federal tax revenues	1.2
	"Initial Impact"	-1.0
	Increase attributable to increase in output and income	2.2

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PRESIDENT

August 18, 1975 (Revised September 17, 1975)

To: John Babson

Subject: Procedures for estimating economic effects of the DISC provisions.

Economic Effects of DISC

Overview

Analysis of the economic effects of the DISC provisions in the Internal Revenue Code must focus on (1) how these provisions affect business taxpayers' costs, (2) how business taxpayers respond to these changes in costs, and (3) how these responses affect major economic magnitudes and Federal tax revenues. The following discussion documents an analysis of the DISC, prepared by Norman B. Ture, Inc. for the Special Committee for U.S. Exports, which proceeds along these lines.

1. Effect of DISC on Business Taxpayer Costs

The initial impact of the DISC provisions is to reduce the cost of capital committed to the production and sale of export goods. "Cost of capital" may be variously defined; in this analysis, it is conceived as the pretax return required on a given amount of capital to make the present value of the after-tax earnings at least equal to the present value of the outlays to acquire the capital. By deferring the Federal corporation income tax on the net income allocated to the export sales, the DISC provisions reduce the required pretax earnings with respect to any given amount of capital used by the taxpayer in export production and sales.

The magnitude of this initial impact clearly depends on a number of factors particular to each business taxpayer, e.g., the discount rate used in the

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company's discounted cash flow calculations, and the type of capital used by the company in its production and sales operations, hence the impact of other tax provisions on its taxes and net-of-tax returns. In focusing the analysis on industries rather than on particular firms, these differences tend to diminish in relevance. Overall, the DISC provisions are estimated to reduce exporters' cost of capital by 18 3/4 percent.

II. Business Taxpayers' Response to Reduction in Cost of Capital

Companies seeking to maximize their efficiency and profits respond to a change in the relative cost of a production input by changing the amount of that input used in combination with other agencies of production. The optimizing condition is that each input is used in such quantity that at the margin it adds just the same amount to the firm's revenues as it adds to the firm's costs. By the same token, the optimum combination of production inputs is such that the ratio of marginal value product to marginal input cost is the same for each input.

In the short run, it may not be possible to alterthe quantity of an input in response to a change in its relative cost. By definition, this is true for fixed capital. Hence, the initial impact of the DISC provisions on reducing the cost of capital does not result in an immediate increase in the amount of capital inputs used in export production and sales. But unless the capital facilities are very highly specialized to export production and sales, implying highly differentiated export products, the time required (1) to shift capital from domestic to export production and (2) to increase the total amount of capital used in aggregate production activity will not be unduly long as a result of technical constraints. In this analysis, a three-year transition period has been assumed.

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The initial response of business taxpayers to the reduction in the cost of capital used in export production and sales is to shift the use of capital, insofar as technically feasible, from domestic to export production. In general, any such shift tends to reduce domestic production relative to export production, hence to increase the pretax returns on capital used for domestic production. If the aggregate amount of capital were fixed, the total effect of the DISC's reducing the cost of capital in export production would be confined to the reallocation of capital, which would continue until net returns at the margin were once more equal in domestic and export production. The fixed amount of capital condition, however, assumes that total saving by business and households is completely unresponsive to changes in the net returns thereto, hence to the cost of saving relative to that of consumption. This assumption is rejected as a conceptual impossibility and as contradicted by empirical evidence. On the contrary, the amount of private sector saving at any pretax return will increase in response to the increase in aftertax returns. Hence, the effect of the DISC provisions is to reduce the cost of capital (hence, the cost of saving) initially in export production but subsequently across the board, resulting in a larger volume of capital and, therefore, capital formation throughout the private sector, not merely in those industries producing for export. 1/

To recapitulate to this point, the initial business taxpayer response to the reduced cost of capital in export production effected by the DISC provisions

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1/ This analysis however does not attempt to estimate the economy-wide effect of the DISC provisions on the cost of capital. Economy-wide effects on capital formation and other economic magnitudes are limited to the increases in output, in employment, and in capital formation in response only to the increase in export sales and in demands by export industries for intermediate products.

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is to increase the amount of capital used for such production. This entails, initially, a shift in the allocation of capital to export production. As the adjustment process proceeds, however, the diffusion of the lower cost of capital throughout the private sector results in an increase in the aggregate amount of capital above the amount that otherwise would be attained. Production, therefore, tends to become more capital intensive throughout the private sector, not merely in export production.

In addition, as the adjustment proceeds, the volume of export production and sales increases more than it otherwise would. For those exports consisting of substantially undifferentiated products sold in world markets, prices are essentially determined by aggregate world market supply and demand conditions. Hence prices are little influenced by changes in the volume of U.S. exports. The elasticity of demand for U.S. exports is therefore very high. The increase in U.S. export volume, therefore, is little constrained by decreases in unit export prices. Accordingly, virtually the entire adjustment is in volume rather than price. When adjustment is substantially complete, the new export volume is that at which export industries' long-run marginal costs are approximately equal to the respective world market prices.

In the case of highly differentiated export products, on the other hand, changes in volume will result in opposite changes in unit price. Total sales revenue, therefore, increases less than in proportion to volume. After adjustment is completed, export volume is that at which long-run marginal cost is equal to marginal revenue and less than price.

The increase in export volume in response to the reduced cost of capital

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involves increases in labor inputs as well as in capital inputs in export production. The extent of the increase in labor inputs depends on the nature of the technical production relationship (i.e. the production function) and the conditions of supply of labor.[2] Hence, although production is more capital intensive when the adjustment is complete, the expansion of export volume results in an increase in total labor input as well.

For purposes of this analysis it is assumed that the increase in employment does not raise the unit price of labor services more than would otherwise occur. Hence, all of the adjustment with respect to the use of labor services in export production is in number of full-time equivalent employees, rather than in wage rate increases in excess of existing trend rates of gain.

In general, most export production and sales involve intermediate goods and services, not merely the value added in export production and sales *per se*. Hence, as export production and sales increase, there must also be increases in intermediate goods production. The export production function, therefore, includes intermediate goods as an input in fixed proportions to output. Estimates of these intermediate goods proportions were obtained from the national income and product accounts published by the Department of Commerce. In this case, too, prices of intermediate goods as inputs to export production were taken as given, unaffected to any substantial extent by the expansion of exports.

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[2] This analysis assumes that the production function is of the so-called Cobb- Douglas variety; the elasticities of output with respect to capital and labor inputs were separately estimated for each of the major export industries for which separate estimates of changes in exports were made.

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The increase in intermediate goods production requires increases in capital and labor inputs. As in the case of export production, it was assumed that wage rates in the intermediate goods industries did not rise more rapidly than their trend rate, so that all of the labor input adjustment was in the number of full-time equivalent employees.

To summarize, business taxpayers respond to the DISC-induced reduction in the cost of capital by increasing capital inputs in export production, along with increases in employment of labor services in this production. As their output increases, export producers also increase their demands for the intermediate products and services used in export production. Producers of these products, in expanding their output, increase employment and add to their stocks of capital in larger amounts than otherwise.

III. Effects on Major Economic Magnitudes and Federal Revenues

Business taxpayers response to the DISC provisions results in an increase in the volume of export production and in sales. In turn, this involves an increase in the amount of capital and labor inputs in such production. It also requires an increase in intermediate goods production, hence in capital and labor inputs for these producers. Increasing the amounts of capital inputs requires larger amounts of capital outlays than would otherwise be undertaken.

In sum, then, the effects of DISC are to be found not only in the increase in the exports component of GNP, but also in the additional value added in the intermediate goods productions (indeed, ultimately, in production throughout the economy) and in gross private domestic capital formation, excluding residential construction. In general, a substantial portion --- 70 - 75 percent --- of the increase in GNP in these categories

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represents increases in payments for labor inputs; on the assumption that wage rate increases remain on trend, the full amount of the increase in wage payments represents increases in full-time equivalent employment.

In making the quantitative estimates of these effects, this analysis works "backwards" from the Government estimate of U.S. merchandise exports in 1974. The 1974 volume and dollar value of exports obviously was larger than it would have been in the absence of the DISC provisions, unless it is unrealistically assumed that business taxpayers are completely unresponsive to changes in costs and in relative returns on alternative uses of the production inputs at their disposal. For purposes of the analysis, it was assumed that business generally had substantially adjusted by 1974 to the effects of DISC provisions on the cost of capital. The analysis, therefore, aims at estimating the volume of exports and intermediate goods production, hence capital outlays, GNP, and employment, in the absence of the DISC. The differences between these estimates and the respective actual observations, accordingly, represent the gains in these economic magnitudes attributable to DISC.

These increases in GNP and employment generate increases in Federal tax revenues. The net effect of DISC on revenues, therefore, is the difference between the estimated amount of corporation income tax liabilities deferred under the DISC provisions and the increase in individual and corporation income taxes, indirect business taxes and payroll taxes associated with the expansion of GNP and employment.

Technical Details

The production function for export goods is assumed to be of the Cobb-Douglas form with respect to capital (K) and labor (L) inputs, but including intermediate goods (M), so that export output is determined as

$$Q = \min \left[f(K,L),\ p^{-1}M \right] \qquad (1)$$

where p designates the proportion of M in Q.

Export production is assumed to satisfy simultaneously

$$Q = A\,K^{a}L^{b} \qquad (2a)$$

and

$$Q = p^{-1}M \qquad (2b)$$

since allowing either of the terms in the brackets in (1) to act as a binding constraint independent of the other at any given level of output implies that some inputs are wasted.

The Cobb-Douglas portion (2a) of the production relation is assumed to have the property of constant returns to scale, i.e., $a + b = 1$.

The total cost of export production is

$$TC = rK + wL + cM \qquad (3)$$

where

r = cost of capital,
w = wage rate, and
c = the unit price of intermediate goods.

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The demand for exports is assumed to have a constant (but not necessarily or even likely unitary) elasticity (n), so that

$$Q^D = (B^{-1}P)^{-n}, \text{ or} \qquad (4)$$

$$P^D = BQ^{-\frac{1}{n}} \qquad (5)$$

where

P = the unit price of exports, and
B = a constant.

Total revenue, therefore, is

$$TR = PQ$$
$$= BQ^{1-\frac{1}{n}} \qquad (6)$$

To maximize profits subject to the production relation constraints (2a) and (2b), the optimum quantity of each input, in terms of the level of output, is

$$K^* = \frac{Q}{A}\left(\frac{aw}{br}\right)^b \qquad (7a)$$

$$L^* = \frac{Q}{A}\left(\frac{br}{aw}\right)^a \qquad (7b)$$

$$M^* = pQ \qquad (7c)$$

Satisfying these optimality conditions, marginal cost, derived from (3) by substituting (7a), (7b), and (7c) into (3) and differentiating with respect to Q, is

$$MC = \frac{1}{A}\left(\frac{r}{a}\right)^a\left(\frac{w}{b}\right)^b + cp \qquad (8)$$

Marginal revenue is derived as

$$MR = \left(1 - \frac{1}{n}\right)BQ^{-\frac{1}{n}} \qquad (9)$$

by differentiating (6) with respect to Q.

The profit maximizing level of output is that at which marginal cost equals marginal revenue, i.e., at which (8) = (9).

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$$Q = \left(\frac{1}{B} \cdot \frac{n}{n-1} \left[\frac{1}{A} \left(\frac{r}{a}\right)^{a} \left(\frac{w}{b}\right)^{b} + cp \right] \right)^{-n} \qquad (10)$$

Given (10), the percentage change in profit maximizing output with respect to a given percentage change in the cost of capital is

$$e_{Q.r} = -rn \frac{\frac{1}{A} \left(\frac{aw}{br}\right)^{b}}{\frac{1}{A} \left(\frac{r}{a}\right)^{a} \left(\frac{w}{b}\right)^{b} + cp} \qquad (11)$$

And from (10), (7a), (7b), and (7c), the percentage changes in the inputs with respect to a given percentage change in the cost of capital are

$$e_{K.r} = e_{Q.r} - b \qquad (12a)$$

$$e_{L.r} = e_{Q.r} + a = e_{K.r} + 1 \qquad (12b)$$

$$e_{M.r} = e_{Q.r} \qquad (12c)$$

The DISC provisions in effect reduce the marginal corporation income tax rate on net income attributable to exports by 25 percent, i.e., at the margin from 48 percent to 36 percent. Where adjustment to the DISC provisions is substantially complete, the after-tax rates of returns on capital in DISCs and in other corporations are equal. Denoting the pretax cost of capital as r_D for DISCs and r_N for other corporations, this condition is

$$\frac{(1 - .48)\, r_N K_N}{K_N} = \frac{(1 - .36)\, r_D K_D}{K_D} \quad \text{or}$$

$$.52 r_N = .64 r_D, \text{ and}$$

$$r_D = \frac{.52}{.64} r_N$$

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Hence, DISC provisions reduce the cost of capital to the DISC by 18 3/4 percent.

Given this decrease in the cost of capital and the elasticities shown in (11), (12a), (12b), and (12c), the effects of the DISC provisions on major economic magnitudes, expressed as percent changes, are

$\dot{Q} = -.18\ 3/4\ e_{Q.r},$

$\dot{K} = -.18\ 3/4\ e_{K.r},$

$\dot{L} = -.18\ 3/4\ e_{L.r},$

$\dot{P} = \dot{Q}/n$, and

$\dot{TR} = (1 + \dot{Q})(1 + \dot{P}) - 1,$

For the calculations, data on ~~aggregate value added~~ were taken from the National Income Accounts (Table 1.14), labelled "Gross Corporate Product." Data on total corporate sales were taken from National Income Accounts (Table 6.19). Intermediate products were estimated as the difference between export sales of corporations and the value added in exports. The deflator for corporate sales and corporate output is the implicit deflator for the gross corporate product. (National Income Accounts Table 1.14).

The labor input measured in terms of full-time equivalent man-years and the average annual wage rate were estimated from data on total business compensation to labor (National Income Accounts Table 6.1) and data on the number of full-time equivalent employees by industry (National Income Accounts Table 6.4). Because these tables cover both corporate and unincorporated business, these figures were adjusted in order to estimate the corporate component. The corporate component was taken to be 68 percent of these values, based on the ratio of income originating in corporate business

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to income originating in total business as found in National Income Accounts Table 1.13. It was assumed that the average wage rate was the same in both corporate and unincorporated enterprises.

Total payments to owners of capital were estimated as the difference between corporate value added and total corporate labor compensation described above. In turn, following the procedure for the labor input, total payments to owners of capital were separated into the volume of the capital input and the average return per unit of capital. Data on net stocks of capital (less residential stuctures) in non-financial corporations is found in "New Measures of Output and Input," Survey of Current Business, March, 1972, Table 3. Residential structures were excluded because they are not a component of export production. Figures for 1973 and 1974 have not yet been published but were made available by the Department of Commerce. The average net pre-tax return per unit of capital was then derived by dividing total payments to capital after capital consumption allowances but before corporate profits taxes by the net (of depreciation) stock of capital. The same rate of return was applied to the export industry estimates of total returns to capital.

The year 1971 was taken as the point of departure for the analysis because DISC was inititated at that time. The 1971 values were used to calculate the relative shares of corporate value added, excluding indirect business taxes plus transfer payments less subsidies, supplied by labor inputs and by capital inputs which are needed to estimate the Cobb-Douglas production function. The shares have been relatively stable; for 1971 the labor share was 73% of value added by non-financial corporations, and the capital share was 27%. The same sources and methods were used to estimate the effects of DISC on all export corporations as well as for such major exports as chemicals,

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transportation equipment (motor vehicles and parts), transportation equipment other than motor vehicles and parts, electrical machinery and non-electrical machinery. Export data were taken from Department of Commerce balance of payments figures, for example, Survey of Current Business, January, 1974, p.522.

The extent of these changes in major economic magnitudes clearly depends significantly on n, the elasticity of demand for exports. For most types of U.S. merchandise exports, the amount of these exports is only a small fraction of total world production and purchases. An increase in U.S. exports, even in substantial amount relative to preceding levels of these exports, will have only a minor effect on the world market prices of these goods. In other words, the rest-of-the-world elasticity of demand for most U.S. exports is very high. To err on the conservative side, an elasticity of 5 is assumed in this analysis, except in the case of agricultural export for which an elasticity of 10 is used. In all likelihood, these elasticity estimates result in substantial underestimates of the effects of the DISC provisions.

Having estimated the effect of the DISC provisions on the volume of exports and intermediate products, on the net stocks of capital in export production, and on employment and employee compensation in export production, it remains to estimate changes in employment and in capital throughout the economy. For this purpose, the ratio of total intermediate goods purchases to total sales by corporations in the export industries was applied to the incremental sales of export producers; the product is the incremental value added in other industries attributable to the increase in exports.

The labor share of this incremental value added in the other industries was assumed to be the same as the ratio of total labor compensation to total value added originating in the business sector. Data on the number of full-time equivalent employees

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in each industry permitted determination of the average wage rates in these industries. Division of the estimated increase in labor compensation in these industries by the average wage rate resulted in the estimated increase in full-time equivalent employees attributable to the increase in DISC exports.

The increase in total returns to capital in the other industries was estimated as the difference between the increase in value added and the increase in labor compensation. Estimates of net stocks of capital (excluding residential structures) in nonfinancial corporations, obtained from the Department of Commerce for the years 1973 and 1974, were divided into total pretax payments to capital, less capital consumption allowances, of nonfinancial corporations to obtain the average net pretax return per unit of capital. Dividing this average pretax rate of return into the estimated increase in net pretax returns to capital in the other industries yielded an estimate of the increase in the net stocks of capital in these industries attributable to the increase in exports from the DISC provisions.

On the basis of Commerce Department estimates of the depreciation and replacement rates for net stocks of fixed capital, estimates of the increase in capital outlays associated with the incremental net stocks of capital in export production and supplying industries were obtained.

Finally, estimates of the effects of the net revenue DISC-induced increase in exports were made by offsetting the Treasury Department's initial impact estimate of the revenue loss in 1974 resulting from deferral of taxes on DISC's net income against the increase in Federal tax revenues resulting from the increases in output and employment attributable to the DISC provisions.

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The increase in total Federal revenues was estimated as the sum of additional tax receipts from three sources: income taxes on income from capital (corporate profits, interest, rents and proprietor's income); income and payroll taxes on labor income (wages and salaries); and indirect business taxes (mainly Federal excise taxes). To determine the appropriate marginal tax rates to be applied to each source, it was necessary to divide national income and Federal revenues into the three categories. National income is readily divisible, but since personal income tax and nontax receipts in the National Income Accounts apply to income earned from capital as well as labor, use of a single average tax rate would understate the rate paid by those receiving income from capital who are in higher tax brackets than the population as a whole. Partial segregation of these capital-income recipients is provided by the 1966 and 1969 editions of Statistics of Income - Individual Income Tax Returns, which classifies taxpayers by major source of income. In each of those years, the average tax rate (tax after credits as a percent of adjusted gross income) for those whose major source of income was capital (business or professional net profit, partnership net profit, dividends included in adjusted gross income, or net gain from sale of capital assets) was approximately 1.67 times as high as for those whose major source of income was salaries and wages.[3] This ratio was used to

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[3] The separation of income sources was nearly but not entirely complete. For those reporting salaries and wages as a major source; other sources supplied approximately 3 percent of adjusted gross income, for those with one category of capital income as a major source, other sources accounted for 17-19 percent of adjusted gross income.

find the average tax rates on capital and labor income, t_K and t_L in the equation

$T = t_K K + t_L L$, where

T = the sum of personal tax and nontax receipts plus contributions for social insurance,

K = the sum of proprietors' income, rental income of persons, and net interest included in national income, and

L = compensation of employees.

"Personal capital-income" tax revenues, $t_K K$, were added to Federal corporate profits tax accruals. The sum was divided by the sum of personal capital income (K) and corporate profits to yield an overall capital tax rate. These calculations were made for 1971-74. In that period, the capital tax rate varied from .323 to .331 averaging .33. In the same period, the labor tax rate climbed from .166 to .190 (reflecting the rise in social security rates and the effect of inflation in pushing individuals into higher income tax brackets). By plotting the logarithm of the labor tax rate against labor income, the labor tax rate was found to rise, on average, 5.7 percent for every $100 billion increase in employee compensation. The marginal rate, that is, the rate on the increment of labor income, associated with these changes in average rate was found to be .33. Finally, an indirect business tax rate of .019 (the rate in both 1973 and 1974) was applied to the sum of labor and capital income plus capital consumption allowances.

The increase in total Federal taxes equals the sum of these three components, i.e., .33 on both the labor and capital shares, plus indirect business taxes. From the resulting amount, the Treasury's initial impact estimate was subtracted to yield a net revenue figure.

APPENDIX C—COMPARISON WITH PRACTICES OF FOREIGN COUNTRIES, WAS MADE A PART OF THE OFFICIAL FILES OF THE COMMITTEE

APPENDIX D

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CHARTS COMPARING U.S. AND

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CHART III. Check List of Tax Incentives for Exports

CHART IV. Check List of Nontax Incentives for Exports

Note: Prepared in 1975 and 1976 from various sources including counsel and accountants in some countries and published sources in all. Since published sources cannot be fully current, there may be some changes not recorded.

TAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Taxation of foreign branch income	Fully taxed at usual rate (progressive rates from 30% to 55%). Deduction for foreign taxes paid. Foreign tax credit upon application.	Exemption of 2/3 of income (effective tax rate of 17.4%).	Exempt except if has not been taxed abroad (tax rates from 47.5% to 50%).	Fully taxed at usual rate (tax rates are from 20% to 45%). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52%). Favorable foreign tax credit system.	Fully taxable at usual rate (46%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, but under conditions less stringent than under subpart F income.
Deductibility of foreign branch losses	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Exempt if at least 25% control.	Exempt if at least 25% control. One-third taxable in other cases.	Exempt in practice.	Exempt.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50%). Partial exemption from 1976. Foreign tax credit.
Special deferrals of taxable domestic income	Investment reserves.	None.		None.	Income may be deferred for: --overseas market development --overseas investment losses --foreign exchange losses	None.
Specific export tax incentives	10% write-off with respect to acquisition of shares in certain foreign entities. Custom free zones.	None.	Deductions and rebates for export market development expenses.	Deduction of 150% of the cost of export related expenditures. Deduction of an amount related to increased export sales.	--Reserves for overseas market development--Deduction of overseas investments. --Reserves for foreign exchange losses. --Special deductions for certain overseas transactions.	None.
Intercompany pricing rules					Favorable treatment for exporting companies.	
Border tax adjustments (VAT)	VAT (rate 18%) zero rate on exports.	None.	None.	None.	None.	None.
Tax incentives indirectly benefiting exports	Accelerated depreciation or tax-exempt investment reserve (1)	Reduced tax rate or exemption from taxation for introduction of new products or processes. Accelerated depreciation.	None.		None.	Tax reduction for manufacturing income. Accelerated depreciation. (1) Investment tax credit.

(1) Most of the tax incentives are granted in connection with industrial and regional development.

TAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Taxation of foreign branch income	[illegible]	Exempt (1) [illegible]	[illegible]	Taxed at usual rate [illegible]. Foreign tax credit.	[illegible] Foreign taxes deductible.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None except if election is made. No subpart F income equivalent.	Yes, but under conditions less stringent than the U.S. subpart F provision.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.
Deductibility of foreign branch losses	Fully deductible even though foreign income is exempt under tax treaty.	Not deductible. (2)	Fully deductible even though foreign income is exempt under tax treaty. (3)	Fully deductible.		Fully deductible.
Taxation of foreign source dividends	[illegible]	[illegible]	[illegible]	Fully taxed at usual rate. Foreign tax credit.	[illegible] Foreign taxes deductible.	Exempt in majority of cases.
Special deferrals of taxable domestic income	None.	[illegible]	[illegible]		None.	None.
Specific export tax incentives	None.	[illegible]	None.		None.	[illegible]
Intercompany pricing rules	[illegible]	[illegible]	[illegible]			[illegible]
Border Tax adjustments (VAT)	[illegible] Zero rate on exports.	[illegible] Zero rate on exports.	[illegible] Zero rate on exports.	[illegible] Zero rate on exports.	[illegible] Zero rate on exports.	[illegible] Zero rate on exports.
Tax incentives indirectly benefiting exports	[illegible]	[illegible]	[illegible]	[illegible] (4)	[illegible]	[illegible]

(1) Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.
(2) Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.
(3) When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.
(4) Most of the tax incentives are granted in connection with industrial and regional development.

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Chart I
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TAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Taxation of foreign branch income	Taxable at usual rate (52%). Foreign tax credit.	Taxable at usual rate. (Average rate 50%). Deduction for foreign taxes paid.	Taxed at half the usual rate (1/2 of 37%). Foreign tax credit.	Exemption on 50% of income (rate is 26.8%).	Taxed at usual rate (effective income tax rate is 54%). Foreign tax credit.	Fully taxable at usual rate (48%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, under subpart F provisions.
Deductibility of foreign branch losses	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Fully deductible.	Fully deductible.		Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate.	Fully taxed at usual rate. Deemed paid foreign tax credit.	Half-exempt if at least 50% control.	Fully taxed at usual rate. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.
Special deferrals of taxable domestic income	None.		None.	Tax free reserves deductible.		About 25% of taxable income may be deferred under the DISC provisions.
Specific export tax incentives	Deduction of business entertainment expenses connected with export activities.	Exemption from corporate taxes on profits attributable to exports of goods produced in Ireland.		Tax free reserves deductible.	Additional deduction for interest charged on export credit.	None, aside from DISC.
Intercompany pricing rules	Not actively used.				Not actively used.	Strictly enforced, including against export industry. Important cases against exporters pending.
Border tax adjustments (VAT)	VAT (8% rate up to 25% for luxury items). Zero rate on exports.	VAT (19.5% up to 36.8% for luxury items). Zero rate on exports.	VAT (15% rate). Zero rate on exports.	VAT (20% rate). Zero rate on exports.	None.	None at Federal level.
Tax incentives indirectly benefiting exports	Favorable rates of depreciation. (1)	Accelerated depreciation. (1)	Tax-free investment reserves constituted by 25% of annual profits. Dissolved after 10 years. (1)	Accelerated depreciation. Tax-free reserves deductible. (1)	Accelerated depreciation. (1)	Accelerated depreciation. Investment tax credit (10%).

(1) Most of the tax incentives are granted in connection with industrial and regional development.

APPENDIX D

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NONTAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Nontax incentives indirectly benefiting exports	Investment allowances (1)		None.			Cash grants. (1)
Financing assistance	Guarantees for medium-term credits. Rate of interest is 7%.				Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5% to 8.75%). Financing of contract value from 60% to 84%. Mixed credits.	
Insurance assistance					Are insured: --production risks --commercial risks --political risks --currency fluctuations --loss of foreign investment. Risks are covered from 80% to 90%.	

(1) Most of the nontax incentives are granted in connection with industrial and regional development.

APPENDIX D

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NONTAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Nontax incentives indirectly benefiting exports	--Interest subsidies --Investment subsidies (1)	--Grants --Investment subsidies (1)	Grants (1)	--Capital grants --Long and medium term loans by specialized government institutions (1)	--Grants --Loans --Guarantees (1)	--Investment subsidies --Interest subsidies (1)
Financing assistance	Discount at low rates. Interest rebates on export credit. Subsidized medium term export financing. Average rate borne by exporters is 9%. Financing of up to 90% of contract value.	Discount at low rates. Long-term loans at 7.9% rate, to both suppliers or buyers. Financing of up to 100% of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10%. Financing of up to 80% of contract value. Mixed credits.	Discount at low rates. Interest subsidies. Long-term loans at 6.85% rate to both suppliers and buyers. Financing of up to 100% of contract value.		Discount at low rates. Guarantees. Subsidized medium and long-term export credits. Average interest rate borne by exporters is 9.8%. Financing of up to 80% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --currency fluctuations Risks covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --market development --exhibition expenses --inflation risks Risks are covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered from 80% to 100%.	Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are 90% covered.		Are insured: --commercial risks --political risks --currency fluctuations Insurance usually covers from 75% to 100% of the risks.

(1) Most of the nontax incentives are granted in connection with industrial and regional development. In Belgium, interest subsidies are granted for the purpose of investment throughout the country and not only in depressed areas.

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NONTAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Nontax incentives indirectly benefiting exports	--Grants --Investment subsidies --Interest subsidies (1) --Employment subsidies (2)	--Investment allowances --Training grants --Loan guarantees (1)	--Loans --Cash grants (1)		--Investment allowances --Loan guarantees (1)	None, except limited agricultural subsidies.
Financing assistance	Guarantees. Interest rate subsidies. Portfolio refinancing. Support granted on a supplier and buyer basis. Interest rate borne by borrowers: 7.5%. Financing of up to 100% of contract value. Mixed credits.	Guarantees. Medium-term loans at preferential rates (8%). Financing of up to 80% of contract value.	Guarantees. Financing of up to 80% of contract value. Interest rate is 8.5% after first year.		Medium and long-term financing at 2% or 3% above discount rate. Financing of up to 100% of contract value.	Discount of medium rates. Guarantees. Long-term export credit financing at interest rates from 8.25% to 8.5%. No mixed credits. Financing of 30% to 50% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --production risks --inflation risks --currency fluctuations --performance bonds Risks are covered up to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations Risks are covered up to 100%.	Are insured: --commercial risks --political risks --currency fluctuations Risks are covered from 60% to 90%.		Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered up to 90%.	Are insured: --commercial risks --exhibition expenses --political risks Risks are covered up to 90%.

(1) Most of the nontax incentives are granted in connection with industrial and regional development.
(2) Granted in order to encourage employers to retain employees.

APPENDIX D

Chart III

TAX INCENTIVES FOR EXPORTS*

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	U.S.
Partial or total exemption on foreign branch income	X	X	X		X				X	X		X		X	X				
Foreign subsidiaries not subject to tax	X	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X		
Foreign branch losses deductible	X		X	X	NA	X	X	X	X	NA	X		NA	NA	X	NA	X	X	X
Partial or total exemption on foreign source dividends	X	X			X	X			X			X	X	X	X	X		X	
Special deferrals of domestic income		X	X	NA				NA		X	NA				NA		X		X
Export tax incentives		X				X	X	X	NA	X	X		X		X	X	X		DISC only
Non-enforcement of intercompany pricing rules	X	X		NA	NA	X	X	NA	NA	NA	X	NA	NA	NA	NA	NA	X		
Border tax adjustments	X	X	X	X	X	X	X	X	X	X			X						

* X indicates country has incentives.
NA indicates that information not available.

APPENDIX D

Chart IV

NONTAX INCENTIVES FOR EXPORTS*

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	U.S.
Nontax incentives indirectly benefiting exports	X	X	X	X	X	X	X	X	X	NA	X		X	NA		NA	NA	X	
Financing Assistance														NA	NA	NA		NA	
- Rate of interest	9%	7.9%	10%	8.00%	NA	8.8%	7.8%	8%	8.5%	NA	(1)	NA	7%				7.5-8.7%		8.25-9.9%
- Portion of contract value financed	80%	100%	80%	85%	NA	90%	100%	80%	90%	NA	100%	NA	NA				48-64%		30-30% (to buyers)
- Mixed credits		X	X														X		
Insurance Assistance					NA					NA		NA	NA	NA	NA	NA		NA	
- Commercial risks	X	X	X	X		X	X	X	X		X						X		X
- Political risks	X	X	X	X		X	X	X	X		X						X		X
- Production risks		X	X				X	X									X		
- Currency fluctuations	X	X	X	X		X	X	X			X						X		
- Performance bonds							X												
- Market developments		X																	
- Exhibition expenses		X																	
- Inflation risks		X	X	X			X				X								X

* X indicates country has incentives.
NA indicates that information not available.
(1) 2% or 3% above discount rate.

Appendix E—Historical Summary of Incremental Approach

BACKGROUND

The Domestic International Sales Corporation (DISC) provisions were enacted as a part of the Revenue Act of 1971.

The provisions as enacted generally provided for the deferral of 50% of DISC income. However, during the consideration of DISC by the Congress, the incremental approach was given considerable attention.

HOUSE BILL

The incremental approach was adopted by the House. As adopted by the House it would have provided that only sales in excess of 75% of average sales for a 1968 to 1970 base period would qualify for deferral.

The Ways and Means Committee Report [H. Rept. 92-533, 92nd Cong., 1st Sess. (Sept. 29, 1971)] stated that the incremental approach was adopted because it concentrated "the benefits of the DISC treatment on firms which increase their exports and thus make a greater contribution to resolving our balance of payments problems."

SENATE BILL

The Treasury Department and virtually all public witnesses testifying before the Senate Committee on Finance opposed the incremental approach. See Hearings before the Committee on Finance, United States Senate, 92nd Cong., 1st Sess., 2 Parts (October 1971).

The Treasury testified that the House Bill would substantially cripple the ability of the DISC provisions to serve their main purpose of keeping jobs in the U.S.

One purpose of DISC was to place companies manufacturing in the U.S. on more of a parity with U.S. companies manufacturing abroad. However, the incremental approach would remove the incentive to keep existing manufacturing plants in the U.S. unless exports increased above the base period level. This problem was illustrated by the fact that one-third of the top 100 exporters showed a decline in exports during the period 1964 to 1967 and that the downward trend had increased since 1967. During a period of decreasing exports, the DISC provisions would provide little or no incentive to U.S. exporters because the incremental approach would provide them with no DISC benefits. This result is particularly unfortunate because this is the time when export incentives are most needed.

From the standpoint of jobs and the balance of payments it is as important to maintain existing export sales as it is to increase such sales. Clearly, an incremental DISC would not provide an incentive to maintain existing exports or help arrest export declines.

The incremental approach is also unfair because it discriminates between taxpayers. Companies which have expended substantial efforts to increase exports during the base period are penalized while companies which have newly entered the export market or entered into a new export program reap the benefits of DISC deferral. This creates an obvious disparity between taxpayers.

In addition, the incremental approach fails to take into account unusual business conditions which may have resulted in abnormally high or low exports during the base period.

Finally, the incremental approach poses extraordinary technical problems. This causes administrative and compliance problems and makes the DISC program of less utility to small businesses. A similar type of incremental approach was urged with respect to the investment tax credit in 1961. However, it was abandoned on grounds that it was inherently inequitable and unworkable.

In summary, the Treasury supplied the following question and answer in a document submitted to the Committee:

> Shouldn't DISC benefits be limited to incremental exports?
>
> The Treasury after very careful consideration of tax deferral only for incremental exports found serious difficulties in this approach.
>
> In an incremental system there is no way to identify firms that are struggling to maintain even their existing export level in the face of increased foreign competition. Yet, continuation of existing export levels by these firms are quantitatively important, as indicated by the fact that over 20% of U.S. exports showed declining or level trends in the period 1965-69. In recent

years, one-third of our hundred largest exporters have had a declining or indefinite export trend. Preserving a dollar of proceeds from existing exports is as important from a balance of payments viewpoint as achieving an additional dollar's worth of export proceeds.

A major purpose of DISC is to overcome the disincentive under existing law to devote resources to exporting as compared with manufacturing investment abroad. We want to remove that disincentive for all exporters, or potential exporters, even though some of them may not be able to show actual increases in exports—at least for a time. But if the latter are induced to do more to prevent further erosion of our existing export base, a real benefit for the balance of payments will result. Hence, considerations of both equity and effectiveness favor the Treasury approach.

Apart from these considerations are the administrative difficulties inherent in an incremental approach. Examples are the selection of an appropriate base from which to measure incremental performance, and the treatment of increases in exports of particular firms due to reorganizations, mergers, or changes in export channels. The incremental aspect was eliminated from the initial investment tax credit proposal in 1961 on the basis of its complexity, as well as its unfairness to struggling industries.

The other witnesses testifying in opposition to DISC generally raised the same problems as the Treasury. However, a few additional arguments were raised.

One argument emphasized the point that the DISC program was intended to offset the various incentives provided exporters by foreign industrial nations. If the DISC program is intended to offset the foreign incentives and make U.S. exporters more competitive, it should be applied to all exports. Existing exports as well as attempts to expand exports are subject to foreign competition. In fact, a taxpayer facing declines in its existing exports due to strong foreign competition would receive little or no DISC benefit.

Another argument against the incremental approach was based on its possible effect on existing trade patterns. Taxpayers will be influenced to change their normal procedures in order to take the incremental approach into consideration when they plan future exports. This could lead to uneconomic decisions which would damage U.S. exporters in the future.

The Senate Finance Committee Report [S. Rept. 92-437, 92nd Cong., 1st Sess. (Nov. 9, 1971)] indicates that the Committee agreed with th testimony that the incremental approach raises substantial equity and administrative problems. Therefore, the Committee deleted the incremental approach and adopted the 50% deferral rule which was accepted in Conference and continues to be the rule under present law.

1975 LEGISLATIVE ACTIVITIES

Since their enactment in 1971, the DISC provisions have been under continual attack. However, no further action was taken on the incremental approach until December 4, 1975, when the House passed the Tax Reform Act of 1975 (H.R. 10612). This legislation has not been considered by the Senate.

The House-passed Bill provides for a similar incremental approach to the 1971 House Bill. The base period limit is again equal to 75% of average base period sales. However, the base period has been moved from 1968-70 to 1972-74. In addition, the base period after 5 years becomes a moving base period instead of the fixed base period in the 1971 Bill. Thus after 5 years the earliest year is dropped from the base and the next succeeding year is added.

WHY THE INCREMENTAL CONCEPT FOR DISC IS WRONG

The basic objectives of DISC will be largely frustrated if Congress adopts H.R. 10612 reported by the House Ways & Means Committee in November 1975 which would impose on the present DISC provisions the so-called "incremental" concept. In simple terms the incremental concept limits the applicability of the DISC benefits to taxable income derived from export receipts exceeding 75% of the average export receipts of a DISC during a three-year base period, which in H.R. 10612 is taxable years beginning in 1972, 1973, and 1974. (In 1981 and later, the base period begins to roll forward, one year at a time.)

1. The incremental concept provides no incentive for maintenance of an existing level of exports. This undermines the basic purpose of DISC, which is to more nearly equalize the tax incentives for manufacturing in the U.S. with the tax incentives for manufacturing abroad. With the incremental concept, particularly with a base period that rolls forward, obviously DISC will provide substantial

aid only to those companies that constantly expand their exports. If substantial DISC benefits are denied to companies engaged in vigorous overseas competition, the U.S. trade balance of payments, which may for the foreseeable future have to finance costly energy imports, may be adversely affected. It is fundamental that an export dollar maintained is an export dollar earned.

2. If the objective of an incremental concept is to spur the expansion of exports, the basic DISC provisions accomplish that objective just as well. If a U.S. company with $100 of base period exports increases its exports to $200, DISC without the incremental concept provides exactly the same tax benefits for the $100 of increased sales as does DISC with the incremental concept. Thus, the incremental concept, rather than encouraging increased exports, operates simply as a disincentive to those companies that are unable to expand their export sales.

3. The present rules of DISC ensure that a DISC will continue its efforts to increase exports. For example, because 95% of its assets must be export related, a DISC, to retain deferral, must invest its profits directly in export items or in producers' loans, which are designed to finance production for U.S. exports. The incremental concept adds no further encouragement to these rules.

4. The incremental concept treats companies in competition with one another unequally. Those companies that have previously responded to governmental programs to stress export sales, rather than manufacture abroad, will find their well-earned incentives taken away from them, while companies that have not stressed export sales in the past will have the initial advantage of the DISC incentives.

5. The incremental concept provides only temporary incentives to companies entering the export field. Once those companies have fully realized their export potential, they are deprived of the incentives that may have initially induced them to expand exports. Any company that takes a long-range view of its export possibilities will see that an incremental DISC only helps them on the way up—it is not a substantial permanent incentive.

6. The incremental concept suffers from the inherent inequities of any base period calculation, which can only be alleviated by extraordinary complexity in statutory and regulatory rules. The excess profits tax laws of World War I, World War II, and the Korean War are well-known examples; none worked well, or evenly, or without extensive litigation. Companies may experience unusual conditions—favorable or unfavorable—in any three-year period, and those conditions must be equalized among all companies by introducing extremely detailed and arbitrary adjustments. Similarly, unusual conditions in the current taxable year must be adjusted to achieve a proper comparison. Complicated rules must be developed to deal with spin-offs, mergers, and sales of business. The focal point of corporate tax planning becomes the manipulation of base period receipts. One need only refer to the ten pages devoted to the incremental concept in H. Rept. No. 94–658, 94th Cong., 1st Sess., pp. 263–273 to realize that DISC would probably become one of the most un-administrable areas of the Internal Revenue Code if the incremental concept becomes law.

7. The language of the 1975 Bill does not resolve the problems of the incremental method dealt with in 1971. In fact, by creating a moving base period, it magnifies a number of the problems. The most significant problem will be the effect of a moving base on cyclical movements in export sales. Over a period of years, exports may rise on the average. However, economically there will be upswings and downswings in such sales over a period of years. The incremental approach with a moving base will result in little or no DISC benefits during a downswing when incentives are needed. The moving base would also increase the discrimination between taxpayers resulting from the adoption of the incremental approach. Unusual business conditions over a period of years will probably create even greater disparity between taxpayers than a fixed base. Finally, the moving base would result in even more market disruption due to additional planning factors and administrative and compliance problems would be substantially increased.

Appendix F—Historical Summary of Agricultural Exclusion

The Domestic International Sales Corporation provisions were enacted as a part of the Revenue Act of 1971. There was no specific limitation in the original legislation applicable to agricultural exports. Section 993(c)(1)(A) which was

added to the Code provided that "export property" included property manufactured, produced, *grown*, or extracted in the United States and which met certain other requirements.

The only provisions which could prohibit agricultural exports from qualifying under DISC were Sections 993(a)(2)(B) and 993(c)(3).

Section 993(a)(2)(B) provides that exports "accomplished by a subsidy granted by the United States or any instrumentality thereof" do not qualify for DISC treatment.

Section 993(c)(3) provides the President with the authority to exclude property in short supply from the DISC program. However, this provision has not been applied by the President.

1974 LEGISLATIVE PROPOSALS

In 1974, the House Committee on Ways and Means reported the Energy Tax and Individual Relief Act of 1974. The Bill made three changes in the treatment of DISCs. One change specifically applied to agricultural products.

The Committee believed that exports of certain products were damaging the U.S. economy. Accordingly, it removed natural resource products (minerals, including oil and gas, and timber) and agricultural or horticultural commodities and products from the DISC program.

In addition to the economic rationale for this change, the Committee felt that these products should be excluded because the production facilities by their nature could not be relocated abroad. Thus, one of the reasons for DISC, *i.e.*, providing an incentive not to relocate abroad, did not apply.

There was an exception providing that the exclusion of these items from DISC treatment does not apply if at least 50% of the fair market value of the product is attributable to manufacturing or processing.

The Bill also excluded from DISC treatment all products the export of which is prohibited or curtailed under Section 4(b) of the Export Administrative Act of 1969 [50 U.S.C. 2403(b)].

No action was taken by the House of Representatives on this legislation.

TAX REDUCTION ACT OF 1975

On March 29, 1975, the President signed the Tax Reduction Act of 1975 which contains provisions applicable to DISCs.

The Act amended the DISC provisions to provide that products on which depletion is allowable do not qualify for DISC treatment. This provision picked up the provisions of the proposed 1974 legislation with respect to natural resources (including the 50% of fair market value attributable to manufacturing requirement). However, unlike the 1974 legislation, agricultural products were not included in the 1975 amendment.

The most significant question raised by this legislation was whether timber, which is subject to cost depletition, is excluded from the DISC program. The statute on its face appeared to exclude timber. However, a parenthetical statement in the provision which listed excluded minerals failed to include timber and Congressman Ullman, Chairman of the Committee on Ways and Means, indicated in his floor statement that timber is not included.

Finally, the Act added section 993(c)(2)(D) to the Internal Revenue Code to provide that items declared scarce under the provisions of the Export Administration Act of 1969 no longer qualified for DISC treatment.

1975 LEGISLATIVE PROPOSALS

On December 4, 1975, the House passed the Tax Reform Act of 1975. The Bill limited the benefits of DISC to all exporters by enacting an incremental limitation on qualifying exports. Thus, only exports in excess of average base period exports would qualify for the DISC program.

The Bill also specifically excluded certain agricultural products from DISC, because the incentive was no longer needed due to high demand abroad. The 50% value-added from manufacturing test was applied. Accordingly, agricultural products meeting this test would continue to qualify for DISC treatment.

The Tax Reduction Act was clarified to provide that timber was not excluded under that Act. However, timber was excluded as an agricultural commodity under the new Bill.

An exception was provided for commodities in surplus supply. The test of whether a commodity is in surplus supply would be whether marketing quotas exist with respect to the commodity under the Agricultural Adjustment Act of 1938 for the year of the sale of the commodity or for two of the five years preceding the year of sale. In addition, specific agricultural commodities are eligible for marketing quotas if the Secretary of Agriculture determines that the supply is excess and farmers vote to have quotas imposed. In recent years, only rice, tobacco, peanuts, and extra-long staple cotton have qualified. However, rice has not had quotas since 1973.

In the event of the repeal or amendment of the Agricultural Adjustment Act, the Secretary of the Treasury, after consulting with the Secretary of Agriculture, can make a determination that a product is in excess supply.

Any agricultural product excluded from DISC coverage in the future is excluded from the base period years for purposes of computing the incremental approach.

The Bill is effective for dispositions made after October 2, 1975, except for dispositions before October 3, 1978, pursuant to certain fixed contracts.

CURRENT PROVISIONS

Since the tax reduction bill is still pending before the Senate Finance Committee, the only pertinent restrictions in present law on the qualification of DISC exports are as follows:

1. Exports "accomplished by a subsidy granted by the United States or any instrumentality thereof" are *excluded* from DISC tax treatment [Sec. 993(a)(2)(B)].

2. "Products the export of which is prohibited or curtailed under Section 4(b) of the Export Administration Act of 1969 to effectuate the policy set forth in paragraph (2)(A) of section 3 of such Act (relating to the protection of the domestic economy)" do not constitute export property and therefore are *not* entitled to DISC benefit [Sec. 993(c)(2)(D)].

3. If the President determines that the supply of any export property is insufficient to meet the requirements of the domestic economy, he may by Executive Order designate the property as in short supply. Any property so designated shall be treated as *not* being entitled to DISC benefit during the period beginning with the date specified in the Executive Order and ending with the President's determination that the property is no longer in short supply [Sec. 993(c)(3)].

THE EXCLUSION OF AGRICULTURAL PRODUCTS FROM DISC IS INAPPROPRIATE

There is no reason to discriminate against the agricultural sector of our economy in relation to the industrial sector. Agricultural commodities are not in short supply. In fact, if a particular commodity becomes in short supply, the existing DISC provisions provide for its removal from DISC treatment.

Agriculture is one of the largest sources of U.S. exports and a major contributor to the U.S. balance of payments. In view of the current world food shortage, U.S. agricultural and agricultural exports should be provided with every encouragement to expand.

The expansion of agriculture not only increase the income of farmers and the number of jobs in agriculture, it also creates numerous other benefits to the economy. For example, the farm machinery and agricultural chemical industries will add to their plant and equipment and labor force.

The expansion of agricultural exports also serves to reduce the cost of U.S. government price supports. At the same time, the expansion and modernization of agricultural facilities due to world demand will create a more efficient production of agricultural commodities and reduce the cost to domestic consumers.

Finally, many commodities are subject to strong foreign competition in foreign markets. In other cases, there is competition from abroad with respect to whether the commodity is processed in the U.S. or abroad.

The DISC provisions in part offset the many export incentives provided by foreign governments. The proposed DISC amendments would reduce the competitive position of U.S. agricultural commodities in the world market. Additionally, in the case of processing which increases the value of the agricultural export by less than 50%, there would be an incentive to move the processing abroad to take into account foreign incentives.

In summary, there is no reason to discriminate against agriculture because the present statute provides rules for removing items in short supply from the DISC program. Agricultural expansion provides economic benefits and jobs to the domestic economy, while alleviating world food shortages, reducing the cost of U.S. government subsidies and reducing the cost of agricultural products to consumers.

Agricultural commodities are the primary U.S. export resource which can be used to offset the exorbitant price levels established by international bodies controlling the price of raw materials such as oil. It is essential that our agricultural productivity continue to grow to offset this growing international trend. trend.

FURTHER COMMENTS

I. AGRICULTURAL EXPORTS ACCOUNT FOR A SIGNIFICANT PORTION OF U.S. TRADE

A. Eport data

The amounts of 1974 and 1975 agricultural exports compared to total exports of all products according to the Economic Research Service of the Department of Agriculture, are shown below:

[Dollar amounts in millions]

	1974	1975
Animal and animal products	$1,776	$1,683
Cotton	1,353	1,001
Feeds and fodders (except oil cake and meal)	272	313
Fruits	596	699
Feed grains	4,646	5,230
Rice	852	858
Wheat and products	4,634	5,353
Other grains	179	170
Nuts	156	160
Cottonseed and soybean oil	695	466
Soybeans	3,537	2,865
Protein meal	999	672
Other oilseed and products	478	449
Tobacco (unmanufactured)	886	877
Vegetables	473	504
Other	467	566
Total, agricultural products	21,999	21,894
Total, nonagricultural products	75,909	86,309
Total, all products	97,908	107,247

B. Balance of trade

In the last several years the U.S. has sustained a deficit in its nonagricultural balance of trade. U.S. imports of nonagricultural goods have increased from $83,986,000,000 in 1970 (the last year in which the U.S. exported more nonagricultural goods than it imported) to $87,624,000,000 in 1975. U.S. exports of nonagricultural products have increased over this time period, but in each year the value of nonagricultural imports exceeded the value of the exports of such products. Fortunately for our overall balance of trade, agricultural exports have exceeded agricultural imports by substantial amounts. Even so, in 1971, 1972 and 1974, the U.S. sustained a deficit in the balance of trade.

The cost of foreign oil imports has, in large part, led to the reduction of our traditional surplus in the balance of trade. U.S. expenditures abroad for aid and defense result in further outflows of funds. The excess of agricultural exports over agricultural imports helps to maintain the dollar as a strong currency and helps to pay for the import of manufactured goods, foreign aid and overseas defense expenditures.

II. AGRICULTURAL EXPORTS FACE STRONG COMPETITION FROM OTHER COUNTRIES

A. Grain, feed grains, and rice

In 1975 the U.S. exported $11.6 Billion worth of grain, approximately 53% of total agricultural exports. The U.S. has competition in the world market for the sales of such goods; Canada, Australia and Argentina should export approximately 25 million metric tons of wheat and wheat flour this year. Western Europe

also should have grain for export. U.S. production of wheat and wheat flour for the fiscal year ending July 1, 1976 is projected (by the Foreign Agricultural Service of the U.S. Department of Agriculture in "Foreign Agriculture Circular, Grains," March 9, 1976, p. 4) to be 58.1 million metric tons or 17% of world production of 341.2 million metric tons. The U.S. will have approximately 35 million metric tons of wheat in excess of the amount necessary for domestic consumption and maintenance of reserves.

U.S. production of feed grains including corn, barley, oats and sorghum should amount to 184.1 million metric tons, or 31.6% of world production of feed grains for fiscal 1976. Approximately 45.8 million metric tons will be available for export by the U.S. Canada, Australia, Argentina, South Africa and Thailand will also be competing for sales in the world market.

For world market sales of rice, the U.S. farmer and exporter must compete against supplies from Burma, Pakistan, the Peoples' Republic of China and Thailand.

B. Oilseeds and meal

U.S. production of soybeans and cottonseed compete not only against foreign production of those goods, but also against foreign production of substitutes including fish meal, peanuts and rapeseed. Brazil, Peru, India, Canada, and other foreign countries account for more than 50% of world production and world exports of these products. Brazilian soybean crops alone should account for 23% of world exports in 1976 ("Foreign Agricultural Circular, Oilseeds and Products," January, 1976, p. 8).

C. Meat

The meat export market principally absorbs items such as Offals (Livers, Kidneys, Heart, Tripe, Lips, etc.) which are not readily consumed in this country. By having the economic incentive to prepare these items for export, the producer receives a better over-all return for the animal, allowing the USA consumer to benefit, and giving the farmer/cattle feeder a better return. For example, on cattle, the exportable items including hides and tallow could represent 30–35% of the live weight of the animal. Therefore, the export market and its further development favorably reflect directly back through the meat producing chain, provided that there is continued incentive for market development.

As a meat exporting country in need of diversified outlets, we compete not only in the free market, but also directly against artificial trade barriers and direct government subsidies to the foreign farmer. The EEC is the best example, with duties of around 17% of CIF value; also direct parity payments to farmers in the EEC for the slaughter of their livestock.

The exporter competes directly against foreign government sales agencies for markets as well.

D. Other products

U.S. production of other agricultural products is similarly subject to stiff competition from foreign competitors.

E. World demand

DISC benefits allow U.S. exporters to compete more effectively for an increased share of world market sales. Current world consumption does not exceed current production plus reserves of agricultural products. Substantial stocks of agricultural products exist. In order for exporters to sell U.S. products, they must meet the competition of goods from other exporting nations. DISC benefits help U.S. exporters to meet foreign competition.

III. EXPORT DANGERS

A. The export of agricultural products involves substantial risks

The export of agricultural products is an extremely risky business. The international demand for U.S. goods is dependent upon the weather during the growing seasons throughout the world, the presence or absence of diseases or pests affecting the size and quality of foreign crops, and on the availability of substitute commodities, such as fish meal from Peru. Not only is international demand affected by such factors, so too is the U.S. supply of exportable products. Within a crop year conditions in the U.S. and abroad may fluctuate, resulting in substantial swings in prices on the world market.

In addition to the many factors that affect the quality and quantity of goods produced domestically and abroad, there are several variables in the transport of the produced goods to destination in the world market. A shortage of railroad cars during the harvest season can mean substantial delays in the shipment of goods, resulting in increased costs. The world price for shipping is also subject to wind swings, causing great shifts in the profitability of export operations.

The greater the volume of foreign sales of commodities, the more difficult and time consuming it is to hedge such sales, and the longer the period in which the seller is subject to violent price fluctuations. Moreover, exporters are unable to hedge against many of the risks and costs affecting them, *e.g.*, certain commodities can only be partially hedged and other substantial risks, such as penalties resulting from strike delays and port congestion, cannot be avoided. Exporters may also have to commit themselves to purchase transportation prior to having firm sales of goods, or may later have to purchase transportation in the volatile spot market. The result is that exporters may become subject to fluctuations in the world shipping market.

B. Profit margins on the export sale of agricultural goods are low

Treasury's 1973 Annual Report on "The Operation and Effect of the Domestic International Sales Corporation Legislation" shows that the ratio of net income to sales for DISC's exporting agricultural products was only 2.8%. For manufactured products the ratio was 8.8, more than 3½ times that for agricultural products. Not only is the margin earned on agricultural sales less than that for manufactured goods, it is substantially less than that earned on the export of other unmanufactured products (approximately 9.8%).

IV. THE IMPORTANCE OF DISC BENEFITS TO THE EXPORT OF AGRICULTURAL EXPORTS

A. DISC benefits help compensate for a portion of the risks of export trade

The availability of DISC benefits increases the profitability of export trade. The increased profitability caused by DISC offsets, in part, the risk of export trade. To the extent that one line of endeavor is riskier than another, the amount of profit to be earned from such line must be greater to induce participation in that line. Most exporters of agricultural products engage in domestic operations as well. DISC benefits offer an inducement to engage in vital export operations.

B. DISC benefits help U.S. exporters meet foreign competition

Agricultural commodity traders located outside the U.S. can structure their businesses so as to pay no U.S. income taxes. In fact, such traders may be able to structure their affairs so as to pay no, or very little, income tax to any jurisdiction. DISC reduces the current tax that must be paid by U.S. exporters and thereby makes them more competitive with traders located outside the U.S.

To the extent that high U.S. income taxes are imposed on those exporting U.S. products, there is a disincentive to export such goods and instead trade in goods produced by other countries.

C. A relevant comment by a meat exporter

"The Meat Export trade is an extremely demanding one, and the exporter constantly asks himself why he is in the business. He is not dealing in nuts and bolts, but with an item that is created by Nature, and is highly perishable. The exporter is involved in complicated marketing techniques and varied specifications to serve the many unique requirements of the importing countries.

"Our industry, which is mainly composed of independent exporting firms, needs DISC and indeed every possible assistance to compete against foreign government subsidies, maintain enough liquidity and available cash flow to continue to promote and introduce USA meat items which essentially have no real market in the States, thus presenting to the farmer, cattle feeder and producer viable marketing alternatives, resulting in an economical package for the housewife.

"Lastly and significantly, the demands of financing an export sale in terms of risk and slow cash flow require a beneficial tax base; otherwise, we, as independent businessmen, must finally say that our energies are best spent elsewhere."

V. EFFECTS OF ELIMINATION OF DISC BENEFITS FOR AGRICULTURAL EXPORTS

A. Reduced share of world markets

Since world production and reserves of agricultural goods exceed current consumption, exporters of U.S. products must compete with sellers of foreign

goods. DISC benefits have helped U.S. exporters to obtain and maintain their present share of world markets. The elimination of DISC benefits would reduce the desirability of exporting U.S. goods as opposed to selling Canadian or Brasilian products.

B. Reduced exports would result in underutilization of human and natural resources

Agricultural production in the U.S. substantially exceeds U.S. consumption; in order to utilize fully our natural and human resources related to agriculture, the U.S. must export agricultural goods. If the agricultural production of the U.S. does not find its way to world markets at present levels, prices received by farmers would fall resulting in less income to them. To the extent that farmers and farm families would be unable to relocate or to shift production, their income would remain depressed. Decreases in agricultural prices accompanied by shifts of farmers and resources out of farming would result in decreased farm production and increased prices to the consumer in the long run.

A decrease in agricultural exports would result in declines in the economy in general. Those dependent upon sales to the farm sector would be hurt first, but in the long run the farm sector depression could affect the entire economy.

Appendix G—Historical Summary of Military Sales Exclusion

Legislative History

The first move to eliminate military sales from DISC benefits from the time of enactment of the DISC provisions in 1971 to the present was the Vanik amendment.

Under the present DISC provisions only three rules could specifically apply to limit DISC benefits in the case of military sales. These provisions are as follows:

1. Exports "accomplished by a subsidy granted by the United States or any instrumentality thereof" are *excluded* from DISC tax treatment [Sec. 993(a)(2)(B)].

2. "Products the export of which is prohibited or curtailed under Section 4(b) of the Export Administration Act of 1969 to effectuate the policy set forth in pargaraph (2)(A) of section 3 of such Act (relating to the protection of the domestic economy)" do not constitute export property and therefore are *not* entitled to DISC benefit [Sec. 993(c)(2)(D)].

3. If the President determines that the supply of any export property is insufficient to meet the requirements of the domestic economy, he may by Executive Order designate the property as in short supply. Any property so designated shall be treated as *not* being entitled to DISC benefit during the period beginning with the date specified in the Executive Order and ending with the President's determination that the property is no longer in short supply [Sec. 933(c)(3)].

Provision Adopted

The Bill as it passed the House, terminates DISC benefits for military goods. Military goods are defined as "arms, ammunition, or implements of war" which are designated on the munitions list published by the Secretary of State pursuant to the Mutual Security Act of 1954 (22 U.S.C. 1934). However, there is an exception for a product on the list which is to be used solely for nonmilitary purposes. Nonmilitary use includes sporting and civil law enforcement uses.

As discussed above, military sales which no longer qualify for DISC are excluded from the base in computing the incremental limitation. In addition, an exception was provided for certain existing binding contracts.

Position on Sales of Military Products

The Committee on Ways and Means adopted various modifications of the DISC provisions after lengthy debate and consideration. Although the Special Committee feels that the existing DISC program is desirable without these modifications, we feel that, in general, the various modifications were fairly considered by the members of the Committee.

However, in the case of the decision on sales of military products there was no consideration during the hearings or the drafting session with the exception of about five minutes during the drafting session in which the decision was reached without a roll call vote. We feel that the area of military sales was not

given adequate consideration and that the proposal adopted by the Committee should be opened for discussion during the final consideration of the Bill.

The sale of military products is a significant factor to the U.S. economy and U.S. employment. The same economic and employment benefits are derived from the export of military hardware as those derived from the export of any other U.S. produced goods.

Sales of military products, whether on a government-to-government basis or on the basis of sales between a company and a foreign government, are extremely competitive. Other industrial nations strongly encourage sales of military products by their manufacturers and provide major competition to U.S. companies. Even though the U.S. government may be an intermediary on the sale of a military product, the U.S. company is required to expend considerable time and funds in obtaining the final contract. Thus, military sales are subject to severe competition equal to or greater than other U.S. exports and should not be singled out for separate treatment.

Finally, any decision with respect to the merits of sales of military products involves consideration of the Foreign Military Sales Act. The tax code is not the proper place to legislate on the merits of military sales.

For these reasons, the Special Committee for U.S. Exports urges that the limitation on sales of military products by a DISC be reconsidered by the Senate Finance Committee. We feel that an open discussion of the issue will lead to a vote to delete this provision from the proposed legislation.

FURTHER COMMENTS

FOREIGN MILITARY SALES

Although almost every foreign military sale is unique in the manner in which the procurement is accomplished, there are some features which are common to every transaction. Basically, the contractor makes the sale after which, for the convenience of the foreign government, the U.S. government negotiates a contract with the manufacturer, pays him, accepts delivery from him, monitors the contract for the foreign government and supports logistics requirements by making the U.S. military service supply system available to the foreign government. The role of the U.S. government has been characterized as "intermediary."

One other feature that is common to these transactions is that the preliminary marketing efforts for a sale are all done by the U.S. contractor, and normally the U.S. government first spends time and money only when a foreign government has decided it wants a product and is ready to negotiate a contract with specific price, delivery, and terms and conditions. The foreign government will have had a specific sales offer from the U.S. contractor and will have made the decision to go to the U.S. government for a government-to-government deal. So it is necessary to understand the money, time and resources which are employed by a contractor in a "preliminary marketing" effort.

As soon as a U.S. contractor succeeds in obtaining a development or production order for a military system (airplane, missile, communications net, etc.) from a U.S. military service, the trade press carries the news and the contractor has expressions of interest from other governments. The contractor tries to assess whether the interest is genuine and as a part of this assessment includes discussions with the Department of State, Commerce and Defense to obtain an informal pulse of U.S. government reaction. He visits the countries which seem to be candidates, talks to the military personnel, government personnel, U.S. Embassy officials and the like in general terms about force structure and overall requirements. Once he has determined that a specific country might have an operational requirement and the money to buy, the U.S. company officially requests permission from the State Department (who consults with the Defense Department) to reveal technical and performance information beyond that which is already in the public domain about the product. Thus, no specific marketing actions can take place until the contractor is assured, through the Department of State, that such a contemplated sale is in the national interest and consistent with U.S. foreign policy.

Once State Department approval is received by the U.S. contractor to open official discussions with the customer, the contractor begins to spend marketing and overhead money in large quantities. He sends teams of operational and technical briefers to the foreign country. He works with the military, the civilian government officials, the bankers, the political leaders and the press to emphasize

the advantages of his product as compared with, say, a British or French competing product which is already being proposed officially by the resident officials of those countries.

The U.S. government depends upon the weapon systems contractor to establish required offset agreements. This process calls for a tremendous number of meetings on both sides of the ocean, between contractor management and manufacturing personnel and governments, labor and industry personnel from the customer country. Major suppliers to the prime contractor are expected to support this type of effort, and they also find themselves in a competitive effort which is expensive and time consuming. The entire success of the sales program can hinge on the offset program which the U.S. companies must offer in competition with those of foreign contractors.

Adding to this expenditure of time and money are the costs for the presentation of specifics, detailed proposals, which cost hundreds of thousands of dollars to put together, and to keep up-to-date in response to specific conditions and requirements which are unique to the foreign government. The U.S. government officials take no action during this period because there are usually two or more U.S. companies competing for the business, and officially the U.S. government will not "take sides." A rigid "evenhanded" policy is maintained. The case of the F-16 was the first instance where a U.S. production decision was made in order that the U.S. government could have only one product in the competition during final evaluation against overseas competitors and, in that way, could become part of the marketing team which makes the "closing" on the contract.

Just recently an overseas government which had decided on one American airplane type was granted permission to visit that contractor only if they visited two other U.S. contractors with competitive equipment. The U.S. government insisted on competition.

After a company had convinced a foreign government about the capability of the product and its cost effectiveness as compared against the British, French or Swedish competitors, the foreign government will probably decide that it might obtain a financial advantage by having the U.S. government add the number of systems required to the U.S. production line in order that the unit price may be lower. At that point, the country officially informs the U.S. government of its requirements and requests a "Letter of Offer." The U.S. government then goes back to the U.S. contractor and requests a whole new series of proposals including prices and delivery for the U.S. government (often on price options already existing in the contract). The U.S. government adds its own fee for handling the mechanics of the negotiation and procurement and thus arrives at a final price which is included in the Letter of Offer which is sent overseas. This action by the U.S. government is the *first* time in some two, three, or even four years of preliminary marketing that there has been any direct expenditure of time or money by the U.S. government in connection with the requirement.

The term "Foreign Military Sales" is really a misnomer. The U.S. government supplies contracting services and, later, support services, in execution of the contract, but has *not spent money, time or effort* in connection with persuading the customer to buy the American product. The U.S. government includes a price in the contract for all those contract support actions which will be taken on behalf of the foreign government, but it is only the private U.S. contractor who has had the overhead and expenses of months, even years, of efforts to bring about the decision to buy. These expenditures include travel for engineers and executives, detailed brochures (usually translated into the customer's language), volumes of technical information, specific mission studies using the country's environment and special conditions, expenses associated with the visits to U.S. plants of foreign evaluation teams, detailed proposals on price and delivery under 50 or more different sets of ground rules, elaborate and intricate financing plans, demonstrations in the U.S. and abroad (the U.S. contractor rents the equipment from the U.S. government for these demonstrations and pays for items such as insurance, transportation, fuel and crew costs), advertising and promotion, establishment and manning of overseas offices, participation in air shows, and much more.

Interestingly enough, foreign competitive organizations often obtain subsidy for the types of expenses noted above or, at least, are granted reimbursement for such items as being "allowable." In addition, the foreign firm has the active support of its diplomatic and military teams in the customer's country from the very outset of a competition, and the military attache of his embassy is con-

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sidered to be a full-time working member of the marketing team. Also, the countries which are our strongest competitors in the sale of military items grant other benefits which are denied the U.S. contractor, such as direct export tax incentives, low interest rates for financing assistance, currency fluctuation insurance, production risk insurance, etc.

In summation, for a sale of military equipment the U.S. contractor has spent more time, money and resources than he has for selling of similarly sophisticated commercial equipment which is purchased by a user, such as a commercial airline, who is only concerned with whether it will make a profit for his operation. The U.S. contractor is allowed less profit in selling to the U.S. government than he can make in a commercial sale, but he has had to deal with 10 to 50 times more people than he does in closing a commercial sale for a civilian product.

When it is all done, the manufacturer of military equipment in the U.S. creates more jobs, just as does the manufacturer of commercial equipment. The identity of the end user should not make any difference in the tax treatment of sales which contribute to our balance of payments and which provide a market for continuing export expansion. Military exports continue to increase and to create jobs thanks primarily to the efforts of the private sector of U.S. industry.

Senator TALMADGE. The next witness is Mr. Robert McLellan, vice president for international and government relations, FMC Corp.

Your entire statement will be inserted in the record and you may summarize it.

Senator CURTIS. If I may inject at this point, Mr. Chairman, Mr. McLellan was formerly a distinguished citizen of our State of Nebraska.

Would you tell us what governmental position you held in recent years.

STATEMENT OF ROBERT McLELLAN, VICE PRESIDENT FOR INTERNATIONAL AND GOVERNMENT RELATIONS, FMC CORP., ACCOMPANIED BY ROBERT MOODY, TAX COUNSEL, FMC CORP.

Mr. McLELLAN. I certainly will.

Thank you, Mr. Chairman and distinguished members of this committee.

I am accompanied by Robert Moody, tax counsel for FMC Corp., and also a former Washingtonian while serving in the U.S. Treasury and with the Joint Committee on Internal Revenue Taxation staff.

Senator Curtis, I spent almost 3 years as Assistant Secretary of Commerce for Domestic and International Business, as well as having been an international businessman since 1950. So I have been privileged to view our Nation's export activity both as a businessman and as an officer of the U.S. Government.

Senator TALMADGE. You may proceed, sir.

Mr. McLELLAN. I appreciate the opportunity to appear before you this morning on behalf of FMC's Robert Malott, whose complete statement has been submitted for the record. Mr. Malott apologizes for the fact that he could not be with us this morning. He did appear before the House Ways and Means Committee last July and prepared a statement at that time. In view of his absence I appreciate the opportunity to be with you.

I would like to briefly summarize our statement in support of the DISC provision. But as background we should note that FMC is a diversified producer of machinery and chemicals with headquarters in Chicago, Illinois. In 1975 our sales totaled $2.3 billion, with $408

million of exports. FMC employs 46,000 people in 32 of the United States and in 13 countries abroad.

It is noteworthy that FMC is comparatively decentralized with each of our 41 divisions having global responsibility for its particular products. In a sense, therefore, I am here today as a spokesman for 41 different international businesses, each of which produces a substantial volume of exports.

I call the committee's attention to an attachment to our statement that describes FMC's recent performance. The statement was originally prepared for submission to the House Ways and Means Committee, comparing our export performance and some related factors between 1971, before DISC was in place, with 1974. Overlaying that you have an update giving the 1975 figures, and from that you will note that our total exports have increased from 101 million in 1971 before DISC (we established DISC in January of 1972) to 1974 exports of $296 million, and in 1975, last year to $403 million.

Looking at the trend lines that you see in the chart to the right of the bar charts, you will notice that our export growth rate from 1964 through 1971 showed an average 11 percent annual increase. Since that time, under DISC, our exports have grown at the rate of 40 percent per year.

We don't submit that all of the export increase is the result of DISC. It is the result of a lot of things, but we submit DISC has been a critical factor.

I would also call your attention to the fact that in terms of jobs, we had export-related employment of 3.584 in 1971. That had grown to 6,971 in 1974 and for 1975 we estimate an export-related employment of 8,093.

In response to the argument that DISC denies the Treasury of revenue, we submit that under our improved export performance we had indeed generated increased revenues.

Our estimates of revenues as the result of our exports in 1971 was $32 million. We estimate now that as a result of FMC's exports, and we are using a multiplier effect, tax revenues rose to $110 million in 1975.

One other point to which I would call your attention is an attachment to our statement that indicates the export assistance programs of other countries as compared to the programs available to companies in the United States.

Senator PACKWOOD. Where is that on your chart? Tax incentives for exports?

Mr. McLELLAN. There are two of them, both prepared for the special committee for U.S. exports. That organization sponsored this work and my company was a party to it along with distinguished accounting and legal firms.

From that, you will note there is a host of export incentives offered by European, Japanese, and Canadian Governments in contrast to the very limited support that the U.S. exporter receives from the Government here.

I would like to offer some personal experience in this connection.

As an international businessman, I have participated in a variety of associations and for years it was my experience that the export in-

dustry was seeking assistance from our Government to help it be competitive with firms in other countries. The U.S. Government, apart from the Export-Import Bank, really had very little to offer in terms of supporting exports. There was a great deal of jawboning on the part of the U.S. Government to the export industries, but very little in the way of positive support aside from some assistance made available through the Department of Commerce.

During the time I was in office as Assistant Secretary of Commerce I was pleased to work with Assistant Secretary of the Treasury Cohen in developing what became the DISC legislation as positive evidence of Washington's desire that American exporters improve their performance. I think it would be a real mistake to now remove that evidence of Washington's desire. The national interest is well served by the exporters of the United States.

If you take time to review this chart, I think you will agree that the advantages that we have, as compared to those offered by our competitors, are very few indeed.

I might add with regard to the GATT situation and referring to Congressman Karth's testimony this morning, the European Community really has little argument at this point under GATT arrangements as far as the DISC is concerned. This is so because their exporters receive so many tax benefits such as the value-added-tax rebate, the offshore trading privileges and so forth. We have a long way to go in establishing equivalence.

Thank you very much.

Senator TALMADGE. Is it a fair statement to say that the United States does less through its tax system to stimulate exports than any other country of the world?

Mr. McLELLAN. That is certainly true.

Senator TALMADGE. Senator Curtis?

Senator CURTIS. You have given a very fine statement. I particularly like these charts because they illustrate the subject matter of your presentation very well.

I was greatly impressed by the earlier witnesses who pointed out that, by reason of DISC, they were able to transport their exports on American-owned ships rather than on foreign ships. That was a new point in my thinking. I was not aware of that. Do you have any comment on that?

Mr. McLELLAN. I really don't, Senator Curtis. As a matter of fact, in the specialized capital goods business and industrial and chemical goods business, it is more a matter of selecting the most efficient shipper. There are limitations on United States versus foreign shipping at times. A leading advantage of DISC, looking at it from a national point of view, is that it has not only permitted us to add jobs directly related to our exporting and marketing activity, but also for every job we add there is an undetermined number of service jobs in the shipping operations, banking, freight forwarding, inland transportation and so forth created as a result of the increased exports, and that is where you get the multiplier effect in the economy.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. Thank you very much for your testimony, Mr. McLellan. I share Senator Packwood's concern in that I think it most important that we give encouragement in every way possible to capi-

tal formation, believing as I do, and I know Senator Packwood does, that the real answer to many of our problems in this country has to be additional job opportunities in the private sector as contrasted with those who would have us address economic problems by proposing Federal programs with make-work jobs.

I would ask you, Mr. McLellan, how do you regard the logic behind this DISC proposal? Your testimony suggests that while you have not quantified it in direct relationship to the increased value of your exports and number of additional jobs created here as saying that that was the direct and exclusive result of DISC, you have said, as I understand you, that there is no question at all but that DISC has been a very important motivating factor in that end result.

What do you think the Congress ought to do as it examines these various proposals, each of which would result in added capital formation? Does not this facet of DISC appeal to you as one that makes awfully good sense, when we are trying to address a problem of unemployment in this country?

Mr. McLELLAN. It certainly does, Senator Hansen. I think we should recognize in terms of Senator Packwood's question to a previous witness, that DISC was designed to increase exports, to provide more jobs in the United States, to provide the means for a balance of trade and balance of payments that the country needs in terms of its international economic affairs.

We must continue to recall that the exporter is entitled to the DISC benefit only to the extent that it is reinvested in export-related assets and that, too, has contributed to the economic growth of the country.

The fact that it must be reinvested in export-related assets then goes to the point that it creates a stronger national posture for a given industry or activity because that capital has been fed back into the industry. That is my argument for continuing DISC for agricultural products as well as the other industries' exclusions that have been discussed in the Tax Reduction Act of 1975 where we lost DISC on depletible minerals, as you know.

We are overlooking the fact that the deferral still has to be invested in export-related assets and that helps industry remain competitive in a particular commodity on a continuing basis.

Senator HANSEN. Recalling earlier testimony that half of the companies in the first year of operation had assets of $10 million or less, those who took advantage of the DISC law, and that 14 percent had assets of less than $1 million, it occurs to me that the reasons and the logic behind continuing DISC might be more persuasive. I am sure everyone is for lower taxes and tax reform means lowering mine and raising yours, and I am for that, but I just have to say I hope the Congress will not escape the logic of encouraging those actions that have a direct result on important national objectives. One of those is to provide employment and get people working again on jobs that are in the private sector.

Is it your opinion the continuation of DISC very certainly gives this hoped-for end result?

Mr. McLELLAN. Very definitely and the problem in my judgment will get worse as we move off what has been a substantial trade surplus of $11 billion. The best estimates we can find for this year are that we will be lucky if we can hold a trade surplus of around $4

billion. The governments of Europe and Japan are becoming increasingly enthusiastic in their promotion efforts and the competition will get more difficult. This certainly is not the time to be moving away from a program that has been very positive in supporting related jobs.

Senator TALMADGE. Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator TALMADGE. Thank you very much, gentlemen.

[The prepared statement and attachments of Mr. McLellan follow. Oral testimony continues on p. 1157.]

STATEMENT OF TESTIMONY OF FMC CORP., BY ROBERT H. MALOTT, CHAIRMAN OF THE BOARD AND PRESIDENT

SUMMARY

FMC is a diversified producer of machinery and chemicals with sales of $2.8 billion and exports of $403 million in 1975:

Prior to DISC, FMC exports grew at an average annual rate of 11%; with DISC, FMC exports have grown at a rate of 40% per year.

During DISC's existence, FMC has created about 4500 additional jobs related to export sales, for a total of about 8100 export-related jobs.

Prior to DISC, taxes paid resulting from FMC's export activity were $32 million in 1971; with DISC those taxes rose to an estimated $110 million in 1975.

DISC has enabled FMC to compete more effectively with foreign firms which benefit from numerous government-granted export incentives. Attached is a chart showing 20 types of tax and non-tax incentives provided by 18 foreign governments. It is apparent that U.S. exporters are provided fewer export incentives than their foreign competitiors.

DISC has become a factor in long-term business planning; it contributes to the national economic recovery now underway; it supports investment in the U.S. instead of abroad.

As DISC has stimulated exports:

Jobs have been preserved and created;

Tax revenues have increased; and

New investment has been made in plants in the U.S. rather than overseas.

STATEMENT

Mr. Chairman and members of the committee: My name is Robert H. Malott. I am Chairman of the Board and President of FMC Corporation, a diversified producer of machinery and chemicals with headquarters in Chicago, Illinois. In 1975 our sales totaled $2.8 billion, with $403 million of exports. FMC employs 46,000 people in 32 of the United States and in 13 countries abroad.

It is noteworthy that FMC is comparatively decentralized, with each of our 41 divisions having global responsibility for its particular products. In a sense, therefore, I am here today as a spokesman for 41 different international businesses, each of which produces a substantial volume of exports.

I appreciate the opportunity to testify before this distinguished committee, and hope that my comments will assist you in your deliberations.

My comments today will focus on the Domestic International Sales Corporation (DISC). However, I am also concerned about the larger question of the future ability of American industry to generate the capital necessary to promote national growth, high employment, and rising productivity. It is widely held that there may be a significant capital shortage emerging in this country. I have written several articles on this subject and, with your permission, I will submit them for the record.

FMC'S EXPERIENCE WITH DISC

Turning now to DISC, I would like first to describe FMC's experience with it, then to examine the impact of DISC on the American economy and its place in the global trading system.

To promote understanding of the DISC, we have prepared a special report and filed it with the committee. This report describes our export growth from 1971 through 1975, and the positive effect this growth has had on jobs and Federal revenues.

I call your attention to the chart attached to my testimony which shows FMC's export sales growth from 1964 through 1975. You will note that, from 1964 through 1971, when we established our DISC, our exports grew at an average rate of 11% per year. From 1972 through 1975, with DISC, they have been growing at the rate of 40% per year. During the period when DISC has been in effect, our export sales have increased fourfold, from under $100 million to $408 million, and we are projecting that the rate of growth under DISC will be impressive again this year.

FMC's increased exports during the past four years have led to the creation of about 4500 new FMC jobs related to export sales, for a total of about 8100 export-related jobs. This is actually a conservative figure as it does not include the additional jobs created by our supplier companies, many of which are smaller firms. Of every FMC sales dollar, 57 cents is spent on purchases from suppliers creating jobs to meet our rising needs.

Taking into account taxes paid resulting from FMC's export activity, we estimate that federal income tax revenues alone increased from $82 million in 1971 to $110 million in 1975. The gain, of course, would be higher if one were to total the overall sum of tax revenues arising from a variety of taxes throughout the production cycle, and at all levels of government.

It is clear that FMC has exhibited an impressive export record since the advent of DISC. In my opinion, FMC export sales in 1975 were substantially higher because of DISC than they would have been otherwise. While I share the view that it is difficult to quantify precisely the positive effect of DISC, it is one of the important interrelated forces influencing our exports. There is no doubt in my mind that because of DISC, FMC has exported more products, employed more people, and increased the taxes we have paid. In addition, it is noteworthy that DISC was a major factor in FMC's strategic decision to build a number of new factories here in the United States rather than abroad.

FMC is by no means unique in demonstrating the positive impact of DISC. In recent years, thousands of American firms have found themselves better able to compete in the international marketplace. The firms which have been exporting most successfully are those which utilize the DISC; the export growth rate of DISC firms was 40% greater than that of U.S. exporters generally in 1973, the most recent year for which the Treasury Department has completed its Annual Report on the DISC.

EXPORTS AND JOB GROWTH

The American public tends to underestimate the importance of exports as they relate to our domestic well-being. In my home state of Illinois, however, the state government reports that 20% of the state's work force relies directly or indirectly upon foreign trade for all or part of its income. Nationally, it is estimated that 8 million jobs depend on exports.

TAX REVENUE GENERATION

Without question, the Federal Treasury temporarily foregoes some income due to DISC deferral. I believe, however, it is incumbent upon this Committee to weigh the direct revenue loss against the total tax revenue generated by the stimulated economic activity resulting from the DISC incentive. Such analysis must take into account the taxes paid by suppliers to exporters, taxes paid by employees whose jobs are dependent upon exports, and a host of other direct and indirect taxes at the local, state and federal level. If one calculates the tax benefits of this corollary activity, our analysts are convinced that net tax revenues are greater than they would be in the absence of DISC. On the basis of data contained in a Treasury Department letter to Senator Long, dated December 20, 1975, it appears that in 1975 DISC stimulated a net increase in federal income tax revenues alone totaling between $.7 billion and $1.7 billion.

INVESTING AT HOME

It is evident that in part DISC was designed to neutralize foreign incentives for U.S. firms to shift production overseas. For FMC, DISC has also meant

increasing investment in the U.S. in plants producing for exports. It was a major factor in our recent decision to invest in the U.S., rather than off-shore, about $100 million in three plants that we hope will export more than 50% of their production. In our special report on DISC you will find the comments that we received from the men on the front line of our export activity. I submit that their comments are persuasive testimony to the key role of DISC as an inducement to invest in America rather than to go abroad.

GLOBAL COMPETITION

In today's worldwide commerce, export performance is greatly influenced by government stimulation and related domestic economic policies. While we welcome open competition with foreign firms, we certainly cannot compete with the vast resources of foreign government treasuries. Yet before DISC this was, in a sense, what we were asked to do—and in many circumstances what we are still required to do.

It is a fact that U.S. exporters were—and remain today—at a disadvantage when confronted with foreign competitors enjoying a variety of export incentives. DISC has made the contest somewhat more equitable, yet even today we are faced with an array of seemingly ingenious tax and non-tax devices whereby foreign governments support their nations' exporters far in excess of assistance given to U.S. exporters by our government.

This situation is well-documented in the 1975 Report of the Export-Import Bank to the Congress. Areas of intervention by the governments of the European community and Japan, which result in more attractive terms than we can offer, include: (1) interest rates; (2) repayment terms; (3) mixing of credits and development loans; (4) inflation offsets; and (5) protection against exchange rate fluctuations.

In the tax area, foreign competitors are advantaged by their governments over U.S. exporters by rebate of value-added taxes and exemption from tax on export profits through use of off-shore trading companies. Such incentives are simply unavailable to U.S. firms.

Appended to this testimony is a chart prepared by the Special Committee for U.S. Exports which identifies the tax and non-tax incentives offered by 18 foreign governments. By examining this chart you will note these foreign practices offer economic benefits noticeably greater than those which U.S. firms have under DISC. Of the nine tax incentives that are generally available to our major foreign competitors, only two are available to U.S. firms, and one of these—Exim Bank financing—provides terms substantially less favorable than those provided to foreign companies by their governments.

To unilaterally dilute those measures designed to assist in putting American business on a more equal footing, in my view, would have substantial adverse repercussions on the U.S. balance of trade and payments. Accordingly, a reduction of DISC benefits should be considered only in the context of reciprocal and simultaneous reduction of export incentives of foreign governments. We are asking no privilege—only that American firms be provided the opportunity to engage in reasonably fair competition to sell American goods abroad.

ECONOMIC RECOVERY

America is emerging from a severe recession, while unemployment remains high. Industry has idle capacity, and economic recovery may be neither strong nor sustained. These economic conditions strongly suggest to me that now is not the time to change the ground rules and possibly detract from a fragile economic recovery. On the contrary, it seems to me that DISC is important in providing a measure of relief from economic malaise.

CONCLUSION

I am convinced that DISC provisions have made a material contribution to FMC's efforts to expand exports. Similarly, I believe DISC has played a very real role in our nation's improving export performance. While I acknowledge that expanding exports are the result of a host of interrelated factors, DISC is important among them.

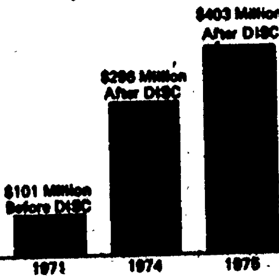
I urge the members of the Committee to continue official encouragement to expand exports, create jobs, and generate tax revenues and foreign exchange by preserving the DISC in its present form. Thank you.

Performance Update, 1975

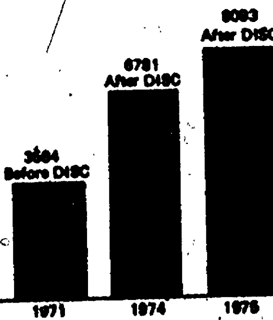
Special Report

How DISC helps FMC Corporation expand U.S. exports, create more U.S. jobs, increase U.S. government revenues

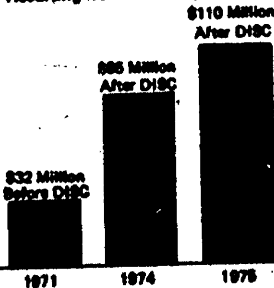
FMC Exports



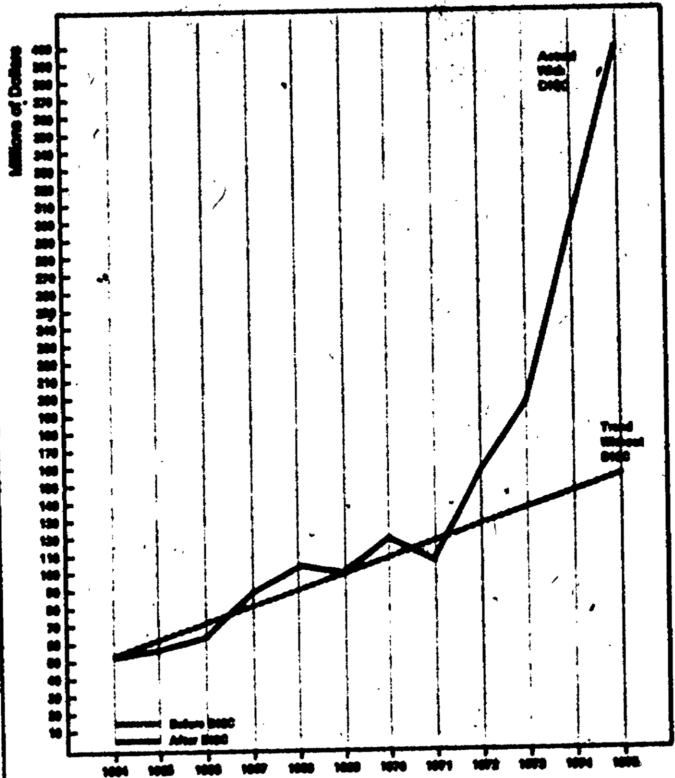
Export Related Jobs



Federal Income Tax Revenues Resulting from FMC Exports



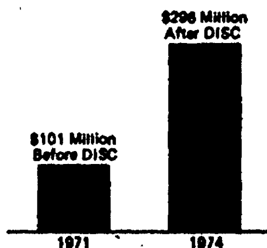
FMC Corporation Export Performance Before and After DISC



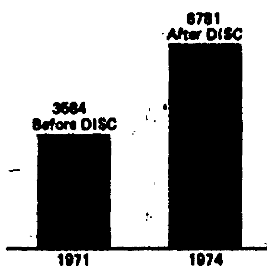
Special Report

How DISC helps FMC Corporation expand U.S. exports, create more U.S. jobs, increase U.S. government revenues

FMC Exports



Export Related Jobs



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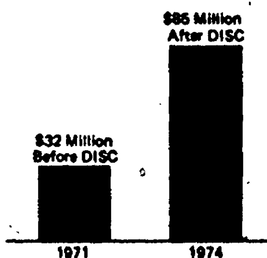


Robert H Malott
Chairman of the Board and President

FMC Corporation
200 East Randolph Drive
Chicago 60601

June 24, 1975

The Honorable Carl Albert
Speaker of the House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

Now that the provision of the tax law known as DISC - Domestic International Sales Corporation - is three years old, we can evaluate its effectiveness in stimulating U.S. exports, creating additional jobs, and increasing federal revenues.

We submit that the experience of FMC Corporation, one of the most widely diversified of our nation's hundred largest manufacturers, can be considered fairly typical of American industry. The dramatic results speak for themselves, and I am convinced DISC has played a material role in our recent success.

FMC has benefited significantly from DISC as have our 50,000 employees, the economies of 33 states in which we operate, and our supplier companies. With FMC's experience, multiplied by the hundreds of business firms employing DISC, it is readily apparent that the provision has been a great asset to the entire American economy.

I think it is critical that you and others in the Congress continue the DISC provision in order to help keep United States industry competitive in the world marketplace.

Sincerely,

Robert H. Malott

cc: The Honorable Al Ullman

WHAT IS DISC?

DISC (Domestic International Sales Corporation) refers to a tax provision of the Revenue Act of 1971 that is designed to increase exports and improve the U.S. balance of payments by putting American exporters on a more equal tax footing with foreign competitors. Before DISC, U.S. corporations were taxed currently on their export earnings at the full U.S. corporate tax rate. Under the DISC provision, U.S. companies pay a tax on 75% of earnings generated from export sales and defer the remaining taxes. As a result of DISC, U.S. companies can compete more effectively from the U.S. rather than build plants in foreign locations to produce the same products.

FMC EXPORTS TRIPLE AFTER DISC

In the three years that DISC provisions have been in effect, the lower tax rate has enabled FMC Corporation to compete more effectively in world markets. Export sales have risen four times faster than domestic sales, increasing from $101 million in 1971, the last year without DISC, to $296 million in 1974. The case histories on the following pages illustrate the contribution of DISC to these increases.

The importance of DISC to exports is reflected by an average annual increase in exports of over 40% a year during the three years DISC has been in effect compared with less than 2% annual growth in the three years prior to DISC.

FMC EXPORT-RELATED JOBS DOUBLE AFTER DISC

In 1971, only 3,584 FMC employees were at work producing products for export. Today, 6,781 employees are engaged in export activities, almost double the number holding such jobs four years ago. The number of employees producing products for domestic sales actually declined during this period.

FMC EXPORTS BOOST FEDERAL REVENUES

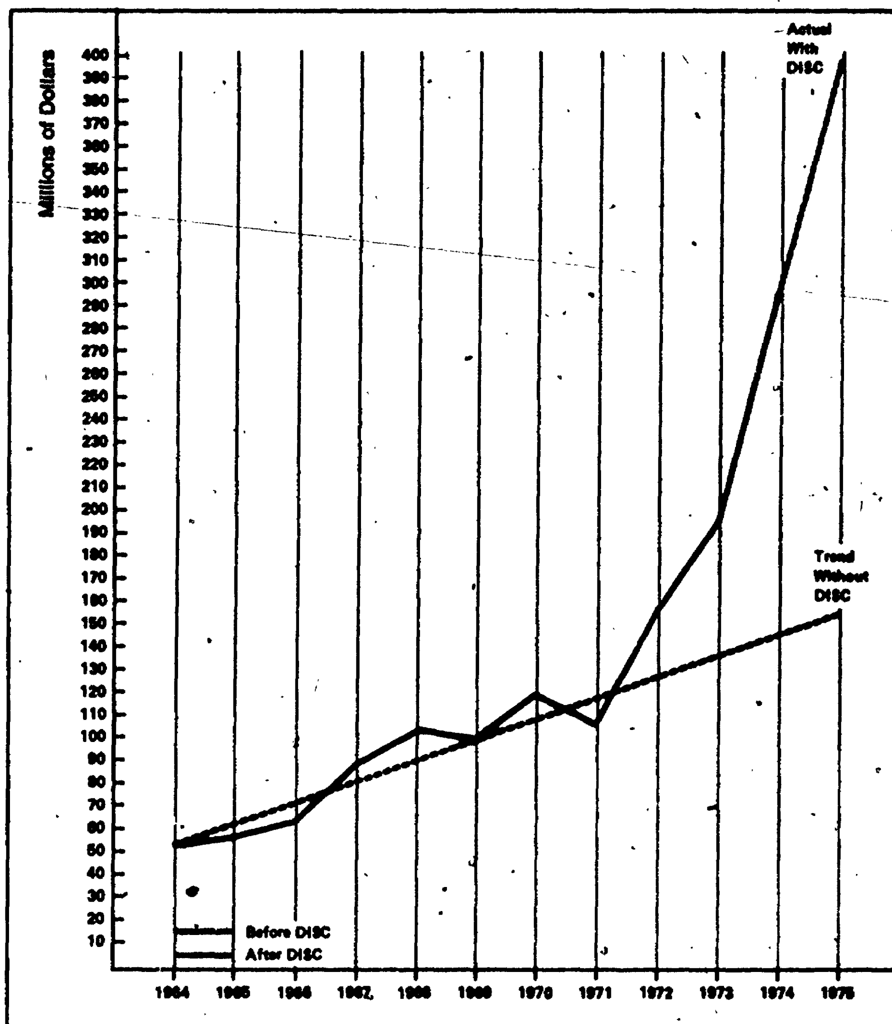
Even though DISC provides for a temporary postponement of the payment of taxes on a portion of export profits, FMC in 1974 paid almost 2.5 times as much in Federal taxes on income from export sales as it paid in 1971. Tax revenue from the increased export volume made possible by DISC more than offset the lower DISC tax rate paid by the company. In addition, DISC provisions created a multiplier effect. Jobs created by export sales gains also meant that additional income taxes would be paid by these 3,197 additional employees. Personal spending by these additional employees as well as jobs and business activity created by FMC purchases from its suppliers added further strength to the economy. We estimate that the combined Federal tax receipts resulting from FMC's export activity approximated $85 million in 1974 compared to $32 million in 1971.

DISC — THE KEY FACTOR IN EXPORTS, JOBS, REVENUES

The successful promotion of exports is obviously no easy task. Success is dependent upon a combination of factors, not the least of which are aggressive management and effective people. DISC, however, remains one of the most effective tools managers have to successfully compete with competitors in countries which provide far more support to their own export business. Several of these, in fact, do not tax the profits on exports at all.

FMC

FMC Corporation Annual U. S. Exports



Case histories — what FMC divisions say about DISC

AUTOMOTIVE SERVICE EQUIPMENT DIVISION — Conway, Ark.; Los Angeles, Calif.

"Our entire operation has been taught to 'think export,' because our Corporate Group and Divisional management have adopted a much more aggressive attitude toward export sales during the DISC years. Our sales increases reflect the results.

"We have adopted an 'export' mode as opposed to manufacturing or licensing overseas. We have hired additional salesmen, and retained salesmen and dealers in overseas countries, in the face of temptations to turn over selected countries to foreign licensees. There have been at least a dozen cases during the past three years where we have turned down opportunities to license in favor of maintaining an aggressive export program."

OUTDOOR POWER EQUIPMENT DIVISION — Port Washington, Wisc.; Aiken, S.C.

"In the early 1970's, we began experiencing a quickening of interest in our product in export markets. We began to seriously consider either a joint venture in Europe or the possibility of establishing our own manufacturing operation there.

"Instead, as a result of DISC, we decided to export the products by reducing our sales price to European customers and pass some of the tax benefits on to the end customer. The strategy has worked well. Our volume has increased and employment in the United States directly related to export manufacturing has substantially increased also."

CRANE AND EXCAVATOR DIVISION — Cedar Rapids, Ia.; Lexington, Bowling Green, KY.

"It is always difficult to isolate a specific decision that was made solely on the existence of DISC. However, there is no question that it has been a major factor in the considerations related to building two new plants at Lexington and Bowling Green, Kentucky, where both plants will export about 30% of their production."

CHAIN DIVISION — Indianapolis, Ind.; Atlanta, Ga.

"In our planning process, the Chain Division International Business Department considered the strategy of manufacturing our products overseas. As we reviewed the growing international markets in Brazil, South Africa, Australia, Canada, Europe, and Latin America, we found that the DISC incentives allowed us to participate in these markets by exporting from Indianapolis."

ENVIRONMENTAL EQUIPMENT DIVISION — Itasca, Ill.

"We recently negotiated one of our largest export sales in history for a sewage treatment plant ($600,000). Because of DISC benefits we priced it below what our normal gross margin would have been. We very likely would not have gotten the job without the DISC benefit."

POWER TRANSMISSION DIVISIONS — Indianapolis, Ind.; Philadelphia, Pa.; Milwaukee, Wisc.

"Some of the costs of doing business overseas are also higher than domestic and not the least of these is the additional capital tie-up in receivables. I, therefore, do not take the Puritan view that the only legitimate use of DISC that is justifiable could be in lowering our pricing. It is also a stimulus to exports by helping to recover higher export costs and to place export business on as attractive a basis as is the domestic market."

FILM AND PACKAGING DIVISION — **Marcus Hook, Philadelphia, Pa.; Fredericksburg, Va.**

"Almost 30% of U.S. industry sales of cellophane in 1974 were in the export market. If the U.S. cellophane industry is to continue as a major employer in the flexible packaging industry, export sales must continue to grow.

"Prior to the establishment of DISC, the return on international sales did not provide an incentive to increase export volume. FMC, in 1971, was operating one plant at full capacity and another at half capacity. The DISC Tax Provision justified increased marketing efforts internationally and by late 1972, both FMC cellophane plants were operating at full capacity and full employment. Total U.S. exports of cellophane have grown from approximately 50 million pounds in 1971 to over 103 million pounds in 1974."

AIRLINE EQUIPMENT DIVISION — **San Jose, Calif.**

"The Airline Equipment Division's exports have increased 500% in the last four years. We have changed our market boundaries from North America and Western Europe to the entire world. Nearly half of our 1975 volume will be exported to 80 countries on six continents.

"There is no question that the DISC tax provisions have complemented our international marketing efforts. Approximately 50% of our major competitors are non-U.S. companies, some with governmental export incentive programs. The DISC tax provisions assist us in being price competitive without sacrificing profit after tax."

FOOD MACHINERY INTERNATIONAL DIVISION — **San Jose, Calif.**

"During the years DISC has been in effect, we dropped manufacture of pea harvesters in Australia because we could export more profitably.

"Sourcing of rotary sterilizers for evaporated milk and other products for Southeast Asia has traditionally been from Australia. Owing to overall cost comparisons during this period, we have been quoting for U.S. supply.

"DISC helps FMI compete with foreign-sourced machinery and projects. Many of our foreign competitors have an advantage over us in terms of freight, duty preference, export financing and export rebates. DISC helps to counteract this."

PUMP DIVISION — **Englewood, N.J.; Indianapolis, Ind.; Montebello, Calif.**

"I believe DEB-22, our program to design and produce a new special model turbo pump for use by shipbuilders overseas, is an outstanding example of DISC influence upon our business and our resulting impact upon the U.S. economy. I do not believe we would have made the decision to proceed with the product, aimed as it is exclusively at export sales, without the cash flow benefits of DISC. We estimate that this product line will directly sustain between 50 and 100 U.S. direct labor jobs in the northern New Jersey – northeastern Pennsylvania area during 1975."

AGRICULTURAL CHEMICAL DIVISION — **Middleport, N.Y.; Baltimore, Md.; Modesto, Calif.**

"The DISC benefit was a determining factor in deciding to carry out a $75 million expansion of two chemical plants in the United States rather than to build new facilities abroad. Nearly 50% of the additional chemical capacity will be for export."

TAX INCENTIVES FOR EXPORTS

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	UNITED STATES
Partial or total exemption on foreign branch income	X	X	X		X				X	X		X		X	X				
No taxation of foreign subsidiaries	X	X		X	X	X	X	X	X	X	X	X	X	X	X	X	X		
Foreign losses deductible	X		X	X	NA	X	X	X	X	NA	X		NA	NA	X	NA	X	X	X
Partial or total exemption on foreign source dividends	X	X			X	X			X			X	X	X	X	X		X	
Special deferrals of domestic income		X	X	NA				NA		X	NA				NA		X		X
Export tax incentives		X				X	X	X	NA	X	X		X		X	X	X		
Non-enforcement of intercompany pricing rules		X		NA	NA	X	X	NA	NA	NA	X	NA	NA	NA	NA	NA	X		
Border tax adjustments	X	X	X	X	X	X	X	X	X	X			X						
Tax incentives indirectly benefiting exports	X	X	X	X	NA	X	X	X	X	X	X		X	X		NA		X	

NONTAX INCENTIVES FOR EXPORTS

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	U.K.	Ireland	Denmark	Norway	Sweden	Switzerland	Austria	Portugal	Australia	New Zealand	Japan	Canada	UNITED STATES
Nontax incentives indirectly benefiting exports	X	X	X	X	X	X	X	X	X	NA	X		X	NA		NA	NA	X	
Financing Assistance														NA	NA	NA			
- Rate of interest	9%	7.5%	10%	13.8%	NA	7%	7.8%	6%	8.5%	NA	NA	NA	7%				7.5-8.7%		10.5%-12.25%
- Portion of contract value financed	NA	90%	77%	85%	NA	NA	85%	80%	75%	NA	NA	NA	NA				48% to 64%		30% to 70% (to buyers)
- Mixed credits		X	X														X		
Insurance Assistance					NA					NA	NA	NA	NA	NA	NA	NA			
- Commercial risks	X	X	X	X		X	X	X	X								X		X
- Political risks	X	X	X	X		X	X	X	X								X		X
- Production risks		X	X				X	X									X		
- Currency fluctuations	X	X	X	X		X	X	X									X		
- Performance bonds							X												
- Market developments		X																	
- Exhibition expenses		X																	

Prepared By The

SPECIAL COMMITTEE FOR U.S. EXPORTS

[From the New York Times, June 21, 1975]

ENCOURAGING CAPITAL FORMATION

(By Robert H. Malott)

There are two interesting statistics that demonstrate that manufacturers in the United States are losing ground in keeping their facilities modern, growing and competitive with industry in other developed nations. Just two years ago, 17 per cent of all United States manufacturing plants were 20 years old or older; today, 21 per cent are 20 or more years old. Or, to put it another way, in 1973, 63 per cent of all United States manufacturing plants were virtually new—that is, less than 10 years old. Now, that percentage has dropped to 57 per cent.

The United States clearly lags behind most other industrialized nations in both capital investment and improvement in the productivity of its labor force. According to the United States Department of Commerce, from 1960 to 1973 private investment in the United States amounted to 19.2 per cent of our gross national product, while investment in Japan amounted to 33.4 per cent of hers. In West Germany, the figure was 26.2 per cent. Similarly, our rate of productivity improvement per man hour in the United States during the same period was only 3.3 per cent compared to 10.5 per cent in Japan and 5.8 per cent in Germany.

In my judgment, the reason for this has been the lack of adequate incentive for industry to invest for growth and to put in place new facilities and modern equipment to improve productivity. One aspect of investment pertains to depreciation regulations, and here in the United States these regulations are substantially less encouraging to industry than they are in most foreign countries.

In the United States, for example, we are permitted to recover only 72 per cent of our investment in the first three years after investment compared to 90 per cent in France, 96 per cent in Sweden, and 100 per cent in Canada and England. If we are to keep American industry competitive during periods of high inflation, it would not be unreasonable to consider the possibility of allowing even more than 100 per cent of cost within a three-year period.

An important stimulant to the growth of American industry in recent years has been the investment tax credit. When it was repealed in 1969, the country went into a period of increased unemployment and reduced business activity. When it was re-enacted in 1971, unemployment declined and investments increased by 9 per cent in 1972 and 13 per cent in 1973.

While the Government's new tax bill enacted in March provides for an increase in the investment tax credit from 7 per cent to the 10 per cent level for two years; and an additional 1 per cent of a company elects to put that amount into a stock fund for employees, this is still less than the 12 per cent investment credit that is considered by some to be necessary for an adequate stimulus to industrial expansion, and which was in fact the proposal of the Senate in its version of the recently passed Tax Reduction Act of 1975.

It is clear, however, that our current Congress, heavily weighted by first-time Congressmen, has enaced tax cuts for individuals that will increase consumer purchasing power without providing an adequate tax reduction for industry to stimulate plant expansion and modernization. Now is the time the United States should have an adequate investment tax credit and one that will be permanent. The record has shown clearly that fluctuation in the investment tax credit cause undesirable fluctuations in the country's industrial growth pattern and, of course, undesirable fluctuations in total employment.

Both Government and industry must realize that despite the apparent but illusory profits of recent years industry faces enormous capital shortfalls in the future. In the last 12 years, United States industry has raised and invested $1.5 trillion. Although that is an impressive sum, it is nothing compared to the estimated $4.5 trillion that will be needed to support a growth rate of as little as 4 percent over the next 12 years. There has been wide discussion recently of how energy availability could be the factor limiting future growth. I feel, however, that lack of adequate investment capital will be at least as serious, if not more so.

The country urgently needs a basic redirection of Federal tax policy to encourage savings and investment as against consumption and to stimulate adequate capital formation sufficient for industry to expand the necessary output of goods and services.

[Editorial]

THE INFLATION FACTOR IN PROFITS

Some economists call it Alice in Wonderland accounting; others talk of profit illusions. Whatever you call it, the facts are that American industry's balance sheets are often not being stated in realistic terms. At first glance, the corporate profits picture for 1974 looks encouraging, with unadjusted net profits for non-financial corporations in the U.S. reaching an all-time high of nearly $70 billion. In addition, overall profit margins of U.S. manufacturers have appeared to be trending upward from 4% of sales in 1969 to 4.8% of sales last year.

But what about these profits? While profits appear to be growing, the real figures, adjusted for so-called "inventory profits" and to compensate for additional costs necessary to replace depreciating assets, indicate that profits for U.S. corporations are actually down in 1974. The adjusted profits in 1974 will be closer to $26 billion, a substantial drop from reported profits and an actual decrease from the $36 billion figure reported in 1973.

Equally as significant is the impact that this adjustment has on the effective tax rates paid by U.S. industry last year. When profits are adjusted for the impact of inflation, the "real" tax on corporate earnings is actually in excess of 70% instead of the apparent 48% rate.

The cause of these shrinking "real profits" and the high rate of taxation is inflation. In mature capital-intensive industries, margins tend to be narrow and inflation rates of even 4% can put some companies in trouble. In 1974, unprecedented double-digit inflation saw to it that almost no company's margin was enough to protect it. Caught in the grip of inflation that can first undermine a company's liquidity and later threaten its very solvency, many U.S. corporations have found that burgeoning profits are due in large part to artificial and misleading inventory profits. As recently as 1971, when wholesale prices were escalating at 3% to 4% per year, inventory profits were less than 8% of the total reported pretax earnings. By 1973 this inventory profit figure had jumped to 18%, and last year it reached a staggering 30% to 35% as rampant inflation boosted the value of goods and materials.

Because inventory profits add to the corporate tax bill that we must pay, the profits picture for industry in 1974 is one of reduced cash flow and insufficient capital formation. In an economic environment where there is no opportunity to tap the equity market, debt becomes the only alternative to the internal generation of cash, and more and more U.S. corporations, as the result of exhausting this debt capacity, are becoming financial resource limited.

Since reduced cash flow means reduced investment, reduced productivity, and reduced growth, we at FMC feel that U.S. industry cannot afford to continue to pay taxes on illusory profit figures. And while "opportunity" was the solution to the go-go growth challenge of the 1960's, the focus of industry's attention during the balance of the 1970's will be on the balance sheet.

For this reason, FMC has recently joined a growing number of companies in announcing plans to change its inventory accounting methods from the First-In, First-Out (FIFO) method to the Last-In, First-Out or LIFO system effective with its year-end 1974 report for nearly all of its domestic commercial (non-defense) operations.

LIFO reduces the impact of inflation on company profits because costs are based on the last price paid for materials, one which more accurately matches the current cost of materials with current prices of goods being sold. Under the old First-In, First-Out system, those costs were based on the earliest materials purchased, allowing inflation to increase the spread between the lowest possible cost and the eventual selling price, and creating an artificial and unfortunately taxable profit increase.

By adopting LIFO accounting, the impact of artificial inventory profits can be reduced. While the immediate effect of adopting LIFO is reduced reportable profits, lower and more reasonable taxes are paid and cash flow for the company is maximized.

For FMC, LIFO will mean a substantial increase in cash savings, reducing our need for outside borrowing and increasing our ability to finance our expansion plans.

ROBERT H. MALOTT,
Chairman and President, FMC Corp.

[Editorial]

FINANCING FUTURE INDUSTRIAL CAPITAL REQUIREMENTS

The most insidious impact of inflation is that the capital formation necessary for industry to meet rapidly escalating investment demands is seriously jeopardized. To overcome capacity shortages, to keep American industry competitive with foreign firms, and to avoid the erosion of the value of stockholder investments in the securities of industrial concerns in this country, the seriousness of this problem must be recognized promptly and dealt with directly.

In the last 12 years, U.S. industry has raised and invested $1.5 trillion dollars. It has been estimated that in the next 12 years industry requirements in this country will be $4.5 trillion—and this to support no more than a 4% future growth annually in economic activity. Our U.S. tax policy will play a critical role in determining industry's ability to "self-generate" these funds which are necessary to replace worn out plants and provide the investment necessary to expand capacity and thereby overcome the production-limited environment that contributes so significantly to inflation. The challenge is clear!

Current depreciation rates (including accelerated depreciation) and the investment tax credit are dramatically inadequate for funds established in this way to play a major role in capital accumulation requirements of this magnitude. In addition, our U.S. depreciation regulations are substantially less encouraging to industry in this country than overseas regulations affecting our foreign competition. While we in the United States are premitted to recover 66% of our investment in the first three years, France provides 90% recovery, Sweden 96%, and England and Canada a full 100%.

The rapid change over the last year in the rate of inflation is compounding our problem and compounding it rapidly. In FMC, for example, based upon inflation rates that have already been in existence since our present plant and equipment has been built and installed, our depreciation rates should be increased by 27% *if we assume no future inflation* until these investments must be replaced. If we assume a 5% future inflation rate—which seems modest in today's environment—the comparable rate at which we should be allowed tax-free accumulation of replacement funds should be increased 87% or if we assume a rate of 8%, we would need to increase our rate of funds accumulation by 147%! And this is merely to keep our existing plants in good running order. If does not provide for expansion!

"Inadequate capital cost allowance" is a sterile and drab subject, remote from the lives of most. The decisions that needed to be made in Washington are as much, if not more, political than economical. The actions needed won't bring short-term, highly visible results but failure to make objective and difficult decisions on the part of those responsible for tax policy will touch the lives of all of us. Insufficient capital will inhibit U.S. industry, including FMC, from the growth justifiably expected by stockholders; it will prevent the expansion necessary to increase employment; and it will guarantee the continuation of a shortage environment that will prevent us from coming to grips with inflation.

Will appropriate tax legislation by itself solve our inflation problem? Of course not! But the significance of depreciation policy is misunderstood by many and under appreciated by others. Capital recapture whether via the mechanism of normal depreciation allowance, accelerated depreciation or the investment tax credit is not a business "boondoggle." In a period of high inflation such as we are experiencing, it is critical to industry survival. I urge you to join with me in redirecting our Federal tax policy toward encouraging appropriate capital formation so critically needed to expand the output of goods and services.

ROBERT H. MALOTT,
Chairman and President, FMC Corp.

Senator TALMADGE. Our next witness is Mr. Robert Matson, chairman, Committee on State Taxation, Council of State Chambers of Commerce, accompanied by William R. Brown, associate research director.

STATEMENT OF ROBERT MATSON, CHAIRMAN, COMMITTEE ON STATE TAXATION, COUNCIL OF STATE CHAMBERS OF COMMERCE; ACCOMPANIED BY WILLIAM R. BROWN, THE SECRETARY AND ASSOCIATE RESEARCH DIRECTOR

Mr. MATSON. I am Robert E. Matson, chairman of the Committee on State Taxation, Council of the State Chambers of Commerce. I am accompanied by Mr. William R. Brown, the secretary and associate research director. The Committee on State Taxation consists of 94 member companies concerned with State income taxation of international and interstate business.

Foreign source income of U.S. businesses is taxed not only at the Federal level, but by the States as well. Today, many companies do business across international boundaries. Many also receive dividends and other investment income from sources outside the United States. Forty-five States now impose taxes measured by income and nearly all of them tax income from foreign sources as defined in the Internal Revenue Code. It has long been recognized that in the case of interstate businesses, all States cannot tax all income, just as in the case of international businesses all nations cannot tax all income.

Many years ago, a three-factor formula was developed to apportion interstate business income among the various States. Each State is supposed to tax income only in the proportion that payroll, property and sales within that State bears to total payroll, property and sales in all States.

That three-factor formula system works reasonably well when applied only to interstate income and when applied only to business income for which it was designed. However, substantial inequities arise when the three-factor formula is applied to income not only outside the State, but outside the United States. The results are often greatly at variance with both the Internal Revenue Code and the basic principles of State taxation. The inequities are particularly acute when State taxes are applied to investment income from foreign sources and when the so-called worldwide combination formula is applied to foreign sources and when the so-called worldwide combination formula is applied to foreign source income.

The Committee on State Taxation has carefully worked out a proposed amendment to the Internal Revenue Code which would establish equitable and uniform rules for State taxation of income from foreign sources generally based on the source-of-income rules under sections 861 through 863 of the Internal Revenue Code. This proposed amendment would still permit all States to impose their income taxes on all foreign source income reasonably related to activity in that State. It was submitted to the House Committee on Ways and Means last year in connection with its consideration of H.R. 10612, and was referred to that committee's Task Force on Foreign Source Income where it is now under active consideration.

We strongly urge this committee to include such an amendment in the currently pending tax reform legislation. The amendment consists of two parts; one related to taxation of foreign source investment income generally and one related specifically to the "worldwide combination" formula as applied to foreign source income. Both aspects

of the amendment are described in detail in the attached appendix which is submitted for the record.

First, the proposed amendment would generally preclude States from taxing that portion of international investment income which is under the Internal Revenue Code allocated to sources outside the United States. This will permit States to tax all income reasonably related to that State; but will avoid multiple State taxation of the same income. For example, some States now tax all the foreign source income of a company headquartered in the State, even though other States have apportioned to themselves and taxed nearly all of that same income. This burden on commerce is compounded by the fact that States do not allow a credit for the foreign taxes also paid on that income and many States do not even allow a deduction for foreign taxes.

Second, the proposed amendment would preclude States from applying the "worldwide combination" formula to foreign source income as defined in the Internal Revenue Code. Even though States clearly are supposed to tax only companies doing business in the State, one or two States now are extending their jurisdiction worldwide by taxing under their apportionment formula the income of all corporations everywhere if related by 50-percent stock ownership to the in-State company, even though those companies are foreign corporations not doing business in the State or the United States.

The results of the "worldwide combination" formula are inequitable and highly distortive.

For example, such a formula may result in an in-State company paying an amount of tax in excess of its income. It may even result in an in-State company with a loss paying substantial income taxes to the State (because the income of other corporations is taxed to it).

The resulting double State taxation and contravention of the Federal principles in the Internal Revenue Code are clearcut. Income of a foreign subsidiary is attributed and taxed directly to the parent even though no dividend is paid. That is contrary to the comparable provisions in Internal Revenue Code which permits deferral. No foreign tax credit is allowed. Again, that is contrary to the Internal Revenue Code. Further; for example, if a parent corporation owns only 50 percent of the stock of a subsidiary, 100 percent of the income of the subsidiary might be taxed to it, and when a dividend is later paid, the same income may be taxed again to other U.S. recipients of the dividend.

The worldwide combination formula is currently used by only a few States; but the trend is growing and if allowed to continue other States will be forced to use this system in order to maintain their relative positions.

The burden on the foreign commerce and affairs of the United States has recently been recognized by the Treasury in negotiating a treaty with the United Kingdom which precludes; for example, a State from applying the "worldwide combination" formula to tax the United Kingdom parent of the United Kingdom subsidiary doing business in the United States. The treaty also imposes the same limitations on local tax jurisdictions in the United Kingdom with respect to U.S. companies.

Although we support ratification of the treaty, the treaty approach is a lengthy country-by-country procedure. Moreover, the treaty does not appear to protect foreign affiliates of U.S. companies.

Immediate legislation is needed to put all countries and all companies—particularly foreign affiliates of U.S. companies—on equal footing.

Therefore, we strongly urge consideration and adoption of the proposed amendment to the Internal Revenue Code.

I thank the committee for its attention.

Senator TALMADGE. I gather from your testimony that some States try to tax income earned in other States even though the corporation or the individual, as the case may be, actually operates at a loss; is that correct?

Mr. MATSON. That is correct; not only in States but foreign countries as well.

Senator TALMADGE. Has that been tested?

Mr. MATSON. It has been tested in courts, including the California Supreme Court.

Senator TALMADGE. What States?

Mr. MATSON. Oregon and California have a unitary approach. Other States are talking about it.

Senator TALMADGE. What courts have upheld such concepts?

Mr. MATSON. The Supreme Court of California.

Senator TALMADGE. Senator Curtis.

Senator CURTIS. I regret that I missed part of your statement. I think your statement deserves much attention and I will read it more thoroughly.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. No questions.

Senator TALMADGE. Senator Packwood.

Senator PACKWOOD. No questions. Thank you, Mr. Chairman.

[An appendix to Mr. Matson's statement follows:]

APPENDIX—PROPOSED LIMITATIONS ON STATE TAXATION OF FOREIGN SOURCE INCOME

PROPOSAL

The Internal Revenue Code should be amended to preclude states from imposing income taxes on non-business income classified as foreign source income for Federal income tax purposes and to preclude the application by states of the "worldwide combination" formula to foreign source income.

BACKGROUND

Many corportaions and other taxpayers do business in more than one state, nationwide, or across international boundaries. Many taxpayers also receive dividends and other investment income from interstate and international sources.

Forty-five states impose taxes measured by income. Obviously, they all cannot tax all the income of a multistate business or investment. Basically, states are entitled to tax only income properly attributable to, or from sources within, that state. States should not tax income which has its source outside the state and is unrelated to the economy and government functions of that state.[1]

[1] Otherwise, the tax cannot be justified as a fair levy for the benefits the state has provided in the creation of that income, double taxation would occur and an intolerable burden on interstate and foreign commerce would result. Within a limited scope, states can and do tax income on a sovereignty or citizenship basis. This is typically the case when individuals are involved and the state of residence (but no other) taxes their salary, dividends, interest and other income. But when interstate or foreign commerce is involved, and multiple taxation would otherwise result, some system of division must be used, whether it be a system of credits in combination with source of income rules as at the Federal level or an apportionment formula as at the state level.

In the case of U.S. source income—where the only problem is to apportion among the states income admittedly having its source in at least one of them—the "UDITPA"[2] three-factor formula system was devised and is now in one form or another reflected in the laws of most states which have income taxes.

The basic premise of the UDITPA system—on which its effectiveness depends—is that if one state applies the formula to allocate a portion of interstate income to itself, each other state will also apply the same formula and the same income will not be taxed by both.

However, in the case of foreign source income, since other countries (as distinguished from other states) do not apply the formula, the system breaks down if any state taxes this income.

LIMITED SCOPE OF PROPOSAL

There are many fundamental deficiencies and inequities in the interstate tax system even when applied to income from sources within the United States.[3]

In some respects, these problems are enlarged and made much more serious when states undertake to tax income from sources outside the United States altogether.

Primarily, however, the current proposal with respect to state taxation of foreign source income is a separate, more narrow issue which can and should be dealt with by a simple amendment to the Internal Revenue Code—wholly apart from the broader and complex question of interstate taxation generally.

GENERAL DESCRIPTION OF INTERSTATE TAX SYSTEM

Prior to discussing the extension of state taxation to foreign source income, the following summarizes the three-factor formula system now most generally used for apportioning income among the states.

A. Business income

Double taxation of the same income by more than one state is sought to be avoided by dividing the total income from the business among the states according to the following three-factor apportionment formula: Tangible property, payroll, and sales within the State times total business income, divided by total tangible property, payroll, and sales within and without the State.

For example, corporation X derives $100 of income from its business which encompasses both State A and State B (but no other). Sixty percent (60%) of the property, payroll and sales of that business is in State A and the balance is in State B. The total income of $100 will be divided between the two states as follows:

State A will tax $60 of the $100 which is in proportion to the percentage of property, payroll and sales located in State A.

State B will apply the same formula and tax $40 of the $100 which is in proportion to the percentage of property, payroll and sales located in State B.

In this case, if the three-factor formula is properly applied, one part of Corporation X's income from the interstate business will be taxed in State A, the balance will be taxed in State B, and the same income will not be taxed by both states.

NOTE.—It is obvious, however, that if State A applied the formula and allocated $60 to its tax base, but State B did not and instead allocated the whole $100 to the tax base, a double tax would result. Such results frequently occur when state income taxes are extended to foreign source income.

NOTE.—It is also obvious that if the formula is applied to more income than the business conducted in States A and B produced (e.g., the $100 of income from the business plus $10 of foreign source dividends), an improper result will be reached. Such results occur when state taxes are extended to foreign source income unrelated to the state.

B. Nonbusiness income

Under the Uniform Act,[4] nonbusiness income (such as dividends, interest, royalties and license fees) is not to be apportioned under the three-factor

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[2] Uniform Division of Income for Tax Purposes Act.

[3] Among these deficiencies are: Taxation of the dividend income of non-domiciliary corporations; inappropriate consolidation of total income of affiliated corporations; and taxation by states in which the corporation does not have a business location. Starting with the "Willis Bill" of 1964, there have been numerous congressional attempts to deal with these problems including several recent bills: H.R. 977, S. 1245, S. 2091, and S. 2811.

[4] Uniform Division of Income for Tax Purposes Act ("UDITPA").

formula. The three factors (property, payroll and sales) relate only to the business income they produce and cannot properly be used to allocate investment income not produced by or related to the presence of these factors in some particular state.

Instead, double taxation of investment income is sought to be avoided by allocation of investment income to the home state (state of commercial domicile in the case of a corporation) or to the state where the investment asset is located or used.

Nevertheless, many states now do extend their income taxes to include dividend and other investment income in their apportionment formula. This results in allocating more than a proper share of income to that state and in some cases in a double tax by more than one state on the same income. The entire dividend, for example, may also be taxed by the state of commercial domicile. This over-extension of state taxes is an important factor with respect to dividend and other investment income from foreign sources.[5]

TAXATION OF FOREIGN SOURCE INCOME

A. In general

The Federal tax law expressly deals with foreign source income, contains detailed provisions delineating income from sources within and without the United States, and provides a credit for the tax paid to a foreign government on income from sources without the United States. In effect, to the extent taxed abroad at its source, foreign source income is not taxed by the United States.

With exceptions primarily related to degree, the basic pattern among the principal nations is to attempt to avoid double taxation. This may be accomplished by a combination of source, citizenship and credit provisions, but countries do not use worldwide apportionment formulas comparable to those used by states to apportion nationwide income.

In contrast to the Federal tax, relatively few state income tax laws expressly address the question of foreign source income and none allow a credit or even a deduction for the income tax paid to the foreign government at the source, but almost all states tax income from sources outside the United States.[6]

The result in the case of foreign source income is frequently a double tax contrary both to the Federal practice and UDITPA apportionment systems used by the states in dealing among themselves.

The explanation of this anomaly is apparent:

a. State laws do not provide for a credit because they are designed to deal with transactions among the states.

b. So long as each state applies the formula properly, income apportioned to one will not also be apportioned to another and no credit is needed.

However, when the state tax is extended to foreign source income, the foreign country is not a party to the apportionment system and will already have taxed the income, all or a part of which the state now wishes to apportion to itself and tax.

This anomaly is illustrative of the basic fact that state tax systems were not designed to apply to foreign source income which in principle they should not tax so long as "foreign source" is properly defined for this purpose.

Most state tax administrators are simply faced with a statute which literally applies to, but improperly deals with, foreign source income. They must, therefore, attempt to collect the tax on foreign source income, despite the substantial administrative complications and inequities involved.

B. State taxes—scope of problem

There are two major aspects to the state taxation of foreign source income.

1. First, the more typical case where the corporation is subject to the state's jurisdiction and the state taxes that corporation's foreign source income even though that income has already been taxed abroad.

2. Second, the so-called "unitary" apportionment formula where the state's tax is in effect extended to take into account foreign source income of foreign corporations outside the state's jurisdiction.

Both aspects can be dealt with by limiting state taxation to U.S. source income under the definition in the Internal Revenue Code, with perhaps a few modifica-

[5] A compilation of the manner in which states tax dividends and other investment income has been supplied to the Staff of the Committee.

[6] In some circumstances, a few states may be considered in effect to allow deduction for foreign taxes.

tions. These carefully worked out rules for determining which part of the income from a foreign-related transaction is U.S. source and which part is foreign source will still permit the states to tax a reasonable portion of the income from foreign-related transactions—to the extent legitimately related to activities in the state.

TYPES OF FOREIGN-RELATED TRANSACTIONS INVOLVED

In general, foreign-related transactions can be divided into those which involve the receipt of investment income (such as dividends, interest, etc.) from foreign sources and those which involve the receipt of foreign source income from the active conduct of a trade or business.[7]

Leaving aside the special difficulty arising from the application of the "unitary" apportionment formula by one or two states which is discussed separately, the problems of state taxation of foreign source income in the more typical case are greater with respect to investment income than with respect to business income. than with respect to business income.

A. Investment income

Dividends, interest, rents, royalties, license and technical fees, gains and other income of this type classified under sections 861 and 862 as foreign source present the clearest case for application of the Federal definition and exclusion of this "foreign source" income from state taxation.

Certainly, in all cases this foreign source income should be excluded from apportionment under the three-factor formula by states other than the state of domicile and even the state of domicile should not tax dividends, interest, etc., on which a credit for foreign tax would be allowed for Federal purposes and which would, therefore, not be taxed to the extent taxed abroad.[8]

Dividends and other investment income classified as foreign source for Federal purposes has no relationship to the state or to activities carried on in that state, other than the fact that the corporation or other taxpayer may otherwise be subject to the state's jurisdiction generally. For example, it is only in recent years that states generally have begun to tax intercorporate dividends even from domestic subsidiaries. States such as New York still do not.

Having in mind that the underlying premise of both the Federal and state systems is to allocate income to the jurisdiction which produced it (and to divide it where more than one contributed), the Federal source of income rules in section 861–862 are a far more reasonable method of doing so—particularly when applied to foreign investment income—than the system employed by the states.

For example, dividends from foreign corporations generally are foreign source and would be excluded from tax by states, but if 50 percent or more of the corporation's business is effectively connected with the U.S., than a proportionate part of the dividend is, under section 861(a)(2), treated as U.S. source income and would be subject to tax by the states. Dividends from domestic corporations doing business both within and without the United States are treated as U.S. source income unless 80 percent or more of the corporation's income is from foreign sources. See section 861(a)(2)(A). Interest from foreign corporations and foreign obligors generally is treated as foreign source, but under section 861(a)(1)(C) where 50 percent or more of the debtor-corporation's business is effectively connected with the United States, then a proportionate part of the interest is treated as U.S. source income and could be taxed by the states.

On the other hand, under sections 861–862 gain from sale of real property located outside the United States properly is foreign source, as are rentals from property outside the United States and royalties (and fees) for patents, etc., used outside the United States.

These Federal rules for determining the portion of income from foreign-related transactions which is U.S. source permit the states to tax all the income that is reasonably related to the economy of each state and produce results which are

[7] In general, the income classified as foreign source under sections 863(b) or 862(b)(3) or (6) (at least to the extent involving tangible property) would be considered as business income and the other types of income classified under sections 861 and 862 would be considered investment income.

[8] In a state tax context, there is no practical mechanism for distinguishing between foreign source income of this category which—in the case of the particular taxpayer and country involved—is or is not taxed abroad at its source. In fact, most of such does bear a foreign tax.

much more consistent with the underlying principles of UDITPA and state income taxation generally.

Certainly, the Federal source of income rules produce more rationale results than the present state rules: (i) arbitrary apportionment to multiple states of the full amount of investment income (without regard to source) based on a formula which was never designed to apply to investment income, plus (ii) in many cases allocation of the full amount to the state of domicile, without in either case allowing for the tax that was paid to the foreign government.

This basic deficiency in state taxation of foreign source income is made worse by such incongruities as the following: in taxing dividends from a foreign subsidiary, some states impose their tax not only on the actual dividend, but on the "grossed up" dividend for Federal tax credit purposes which is, of course, a hypothetical figure from an intermediate calculation on the Federal return.

B. Business income

Where the foreign-related income is from business activity [9]—such as manufacture of goods in the U.S. and sale abroad—the portion of the income allocated to a state under the three-factor formula may not in some cases be too different from the portion of the income which is under the Federal rules classified as U.S. source income. Overall, however, even in the case of business income, the Federal definitions of U.S. source and foreign source reach more appropriate results than the three-factor formula.

Because the results are more similar, the Federal rule could be applied without any significant effect on the income tax base of states, or the state rules could in this limited area be left in effect with less adverse effect on international business transactions than in the case of investment income.

The following examples of foreign-related income from business activity illustrate the differences in the amount that would be taxed by the state depending on whether the three-factor formula is applied to the whole amount or only to the amount defined as U.S. source under the Federal definition.

a. Manufacture in United States and sale abroad

(i) Under section 863(b)(2), the total income is classified as partly within the U.S. (the manufacturing portion) and partly without the U.S. (the sales portion). Under either of the two methods of allocation—one of which is a two-factor formula based on property and sales—it is likely that 50 percent to 70 percent of the total income would be allocated as U.S. source.

(ii) Under the states' three-factor formula the sales factor would be outside the state and the payroll and property factors would be largely (or altogether) within the state. Thus, assuming, as might be typically the case, that the dollar amount of each factor is one-third of the total, approximately 66 percent of the income from the manufacture and sale would be allocated to and taxed by the states.

NOTE.—If states are limited to taxing only the U.S. source portion (e.g., the 70 percent in subparagraph (i) above), the property, payroll and sales factors under the three-factor formula would be adjusted to take into account only property, etc., within the U.S. That formula would then be applied to the U.S. source income and apportioned among the states accordingly.

b. Manufacture abroad and sale in United States

Under section 863(b)(2), using the same example, the result would be the converse of manufacture in the U.S. and sale abroad. Approximately 30 to 50 percent would be classified as U.S. source income and taxable by the states if the Federal rule is applied, and about 30 percent would be taxable by the states under the present three-factor formula.

c. Purchase in United States and sale abroad

(i) Under section 862(a)(6), the total income is classified as foreign source.

(ii) Under the states' three-factor formula, the sales factor would be outside the state and the property and payroll factors would be within the state. Typi-

[9] This would include income from manufacture of goods in the United States and sale abroad (or vice versa), income from purchase of inventory and similar personal property in the United States and sale abroad, income from transportation services partly within and without the United States and income from labor or services rendered abroad. The treatment of DISC income under section 991–997 is not a part of the proposal to apply Federal foreign source definitions.

cally, the latter two factors combined would be substantially less than the sales factor. The bulk of the total income (perhaps 80 percent or more in many cases) would be allocated outside the states and not taxed by the states.

NOTE.—Under the so-called "throwback" rule employed by many states, if the sale was not taxed abroad, the sales factor would be included as a "sale" in the state from which the shipment was made, for purposes of applying the three-factor formla to that state. In that case 100 percent would be taxed by the states.

d. Transportation (and other services) partly within the United States

(i) Under section 863(b)(1), the total income is classified as partly within the U.S. and partly without, on the basis of the relative proportion of costs (within and without) and a reasonable rate of return on investment (within and without the U.S.).

(ii) Under the states' three-factor formula, in the case of an airline, e.g., the three factors in each state would be determined on various statistical bases in part related to passenger miles, and the three-factor formula would then be applied in the usual manner.

e. Labor and services rendered abroad

(i) Under 862(a)(3), this total income is classified as foreign source.

(ii) Under the states' three-factor formula this income would simply be included in the total income base to which the formula is applied and apportioned in the regular manner based on property, payroll and sales, There would in this case likely be some "sales" and some payroll factor outside the states.

NOTE.—In the case of individuals who reside in the state and receive compensation for services abroad, this income typically would be taxed in full without apportionment.

WORLDWIDE COMBINATION OR UNITARY

Up to this point, the focus has been on the more typical case of state taxation of foreign source income, i.e., where a state simply extends its tax to include the "foreign source" portion of the income of a corporation or other taxpayer which also has some domestic source income from that state and which the state is otherwise entitled to tax (on domestic source income).

That situation alone is significant and requires correction. However, one or two other states not only extend their tax to foreign source income, but also extend their tax to foreign source income of corporations outside their jurisdiction.

For example, under the "worldwide combination" system, the ordinary three-factor formula is applied by the state on a worldwide basis.

a. The income of a foreign parent corporation (operating totally outside the United States) is combined with the income of a subsidiary corporation that does business in the state. This total income is taken into account under the formula and a portion of the income of the foreign corporation is in most cases taxed by the state.

b. The income of a foreign subsidiary corporation (operating totally outside the United States) is combined with the income of parent corporation doing business in the state. This total income is taken into account under the state's three factor formula and, typically, a portion of the foreign subsidiary's income is taxed currently to the parent corporation.

NOTE.—The foregoing result with the foreign subsidiary amounts to a "deemed dividend" (or ending of deferral) for state income tax purposes which is expressly contrary to the longstanding rule for Federal income tax purposes. Under the Internal Revenue Code the income of a foreign subsidiary is generally not taxed to the parent corporation until paid out as a dividend.

This unitary apportionment system is the most extreme case of extra-territorial extension of state income taxes to foreign source income. Taxing the income of a foreign parent corporation to the U.S. subsidiary (or vice versa), is contrary to the basic international framework which will adversely affect the United States both in terms of foreign investment in the U.S. and investment by U.S. companies abroad. The burden upon, and interference with, the foreign commerce and affairs of the United States is recognized in the recently signed treaty between the United States and the United Kingdom. Article 9, section 4, of that treaty precludes states from applying the worldwide combination or unitary formula to two or more related U.K. corporations. Ratification of this treaty will increase the need for legislation to apply the same limitation on state taxation of (i) related corporations of countries other than the United Kingdom and (ii) the foreign subsidiary, for example, of a U.S. company.

The following additional deficiencies of the worldwide combination system of state taxation are also apparent:

a. Substantial distortions and tax liability necessarily result from the complexity and basic nature of the unitary system. For example, 100 percent of the income of a 50 percent owned subsidiary is attributed to and taxed to the parent, even though its interest in the income is only 50 percent. When the income of the subsidiary is paid out as a dividend, it will again be taxed (to the recipient) by that state or, in the case of the 50 percent of the dividend received by the parent corporation, by some other state. Although the state which applied the unitary formula to "deem" the dividend to the parent corporation would not ordinarily again tax the parent on the dividend when actually received, other states will apportion at least a part of the dividend received by the parent corporation and tax it again.

b. Application of the unitary approach by one or two states may increase their revenues (at least temporarily) and other states will be motivated also to adopt that system, widespread use of which would magnify the role and burden of state taxes totally out of proportion.

c. Although states may temporarily gain revenues from extension of their jurisdiction in this manner, the unitary apportionment may also result in a reduction of taxes by inclusion in the combined group of affiliated companies with tax losses.

d. Application of the unitary apportionment system in effect results in applying the three-factor formula to passive investment income contrary to basic principles (i.e., taxing the income of a subsidiary is the same as taxing a "deemed" dividend from the subsidiary). The three-factor formula was designed for, and produces a reasonable result only with respect to business income.

The unitary apportionment system is sought by some to be justified as a substitute for section 482 of the Internal Revenue Code to readjust artificial shifting of income between related corporations; and that states do not have access to sufficient data or financial information about out-of-state or foreign corporations to make certain that section 482 is being properly applied.

To the contrary, section 482 and its proper application is of even greater importance in the Federal tax than at the state level, is fully and properly applied and all such adjustments are readily available to the states most of which base their taxes on Federal tax data. In addition, proper application of the unitary formula requires just as much or more data about out-of-state and foreign corporations as does section 482.

Moreover, the unitary formula is applied by states to all income of the related corporation whether or not arising from transactions with the parent or subsidiary (and in some instances even when there were no such transactions) and without any relationship to whether section 482 adjustments were or could have been made at the Federal level.

Proponents of the unitary apportionment system may also assert that application of the formula does not tax income of a foreign corporation (or a corpration outside the state), but merely takes that income into account in measuring the income of the related corporation which is – thin the jurisdictiof of the State. That on its face is a logical nonsequitur.

In fact, so long as the amount of tax is greater when the unitary formula is applied than it would be if the unitary formula is not applied, either the income of the foreign corporation was taxed or a discriminatory higher rate of tax was applied to the in-state corporation. So long as the ratio of the three factors (property, payroll and sales) to income is not identical within and without the state, a difference in the amount of tax will always result from application of the unitary formula. Typically, costs of labor, etc., are lower in some foreign countries (and in some states) than in the particular states which are applying the unitary formula. The unitary formula allocates additional income and tax to the higher-cost states.

There are even instances in which the amount of taxes owed under the unitary formula (by taxing the income of a whole series of corporations outside the jurisdiction) exceeds the total income of the in-state corporation.

Thus, the unitary apportment formula is just what the name implies—treating all related corporations as a unit even though only one is subject to the state's tax jurisdiction.

Senator TALMADGE. Ou next witness is Mr. Paul D. Seghers, president of the International Tax Institute, Inc., of New York.

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INTERNATIONAL TAX INSTITUTE, INC., OF NEW YORK

Mr. SEGHERS. Thank you, Mr. Chairman.

My name is Paul D. Seghers, president of the International Tax Institute, Inc., of New York.

The ITI is an association of tax executives, accountants and lawyers representing principally U.S. manufacturers engaged in foreign trade. It was incorporated in 1961 and its members are located throughout the United States.

We are grateful for the opportunity to present to this committee the ITI's position regarding U.S. taxation of DISC export income and income from U.S. foreign trade.

We are happy to note that this committee, in performing its vital task, is considering carefully the facts in the record, and is not allowing itself to be swayed by the false and unfair charges that U.S. business abroad results in "exporting jobs" and draining capital from the United States.

BUSINESS COMPLIES WITH CALL FOR FACTS

For several years business has been told that it must present facts to support its position regarding the effects of DISC and U.S. foreign trade on U.S. exports, employment in the United States' capital formation, and the U.S. economy. The record of hearings of the tax committees of both Houses of Congress show that business has done an excellent job in presenting those facts in response to that admonition. Business has presented in great detail facts that prove that U.S. business abroad has increased U.S. exports and jobs in the United States, and has brought and is bringing home to the United States far more money than it has invested abroad. I wish more Senators on this committee would hear what I am saying. I hope to God they will read the words in this statement. We stress these basic points:

(a) First—the record shows that business has presented facts as to the benefits to U.S. exports, U.S. employment and the U.S. economy that have resulted from DISC and from U.S. business abroad.

The record is full of attacks on that business, unsupported by facts. I repeat—the charges against business have not been supported by facts and they contain many false, lying statements.

(b) Next—added burdens of U.S. taxes on income from exports and U.S. business abroad will reduce the amount of that income and the resulting tax revenue. This can be only an opinion, but it is based on facts and has been expressed by many witnesses competent to testify on this point.

The loss of the inflow of income to the United States and the resulting loss of U.S. employment and taxes are not mentioned by those who so loudly contend that the imposition of these added U.S. tax burdens on DISC income and income earned abroad would increase the U.S. income tax "take." That is a false conclusion based on false statements.

(c) Finally—if increased U.S. tax burdens imposed on U.S. foreign trade make it impossible for U.S. business to operate abroad, presently

U.S.-owned plants would fall into the hands of foreign manufacturers not similarly burdened by their governments. The consequences would be loss—not increase—in U.S. exports, loss of world markets for U.S. products and increased competitive advantage afforded foreign manufacturers in the U.S. market. No need to point out what that would do to employment in the United States.

FACTS ABOUT DISC

Now let us consider some of the provisions of H.R. 10612 and the additional provisions being demanded by Mr. Meany and his supporters.

We will commence with the provisions of H.R. 10612 that would reduce the benefits of DISC; Mr. Meany's demand for its immediate repeal; and our recommendation that DISC should be changed only to the extent necessary to make it more attractive to smaller U.S. manufacturers.

Ample facts have been presented to your committee, as well as to the Ways and Means Committee, to prove that DISC has been effective in increasing exports of U.S. manufactured products and that repeal or severe curtailment of DISC benefits would result in loss of U.S. exports and loss of jobs in U.S. factories. The hearings reports show that these facts have been presented both in the form of statistics and as statements by U.S. manufacturers regarding their own experience with DISC. Similar facts have been submitted to us—that is, to the International Tax Institute—by its members representing many U.S. manufacturers, both large and small.

WHY DOES MR. MEANY DEMAND REPEAL OF DISC?

As DISC is of no benefit except to defer part—usually only 25 percent—of the U.S. tax on income from the export of U.S. products, and such exports result in jobs here at home. Why does Mr. Meany demand the repeal of DISC? Why are certain persons supporting his demands? That is a vital question that deserves some thought. There seems to me to be only one logical answer to those questions.

HOW TO MAKE DISC MORE EFFECTIVE

One way to make DISC more effective would be to make it more attractive to smaller U.S. manufacturers. This could be done by allowing deferral of 100 percent of the U.S. tax on the first $100,000 of DISC income. That would not be a loss of tax revenue—only a temporary deferral of the time for payment of the tax. Talk about deferral for a lengthy period of time reveals either a lack of understanding of the DISC provisions and the realities of business life, or a deliberate effort to mislead.

We urge this committee to eliminate the provision in H.R. 10612 that would reduce the benefits of DISC and to substitute provisions that would make DISC more attractive to smaller U.S. manufacturers and thereby increase further U.S. exports and U.S. employment.

Let me repeat and stress over and over again that the statement that the manufacturer can defer 50 percent of his export profits is false.

Fifty percent of 50 percent is 25 percent and I will go into that further; but it is not a 50-percent deferral of the manufacturer's export profits.

Say the smaller manufacturer makes $300,000 export sales and realizes taxable income of $60,000. Half can be treated as DISC income, $30,000. The other half is taxable. Plus one half of the DISC income. The tax on the remaining DISC income of $15,000 can be deferred—$6,200. That is a big deal. The wonder is that there are so many DISC's today.

We urge this committee to eliminate the provision in H.R. 10612 that would reduce the benefits of DISC and to substitute provisions that would make DISC more attractive to smaller U.S. manufacturers and thereby increase further U.S. exports and U.S. employment.

We limit our oral discussion to manufactured products.

MR. MEANY'S DEMAND FOR REPEAL OF THE FOREIGN TAX CREDIT

Next we will discuss Mr. Meany's demand for repeal of the foreign tax credit, although we feel this committee would hardly consider adding such a harmful provision to H.R. 10612.

Repeal of the foreign tax credit would result in aggregate U.S. and foreign taxes of more than 70 percent on income of U.S. businesses in most Western European countries, Japan, and India. This would ruin U.S. business in the largest market abroad for U.S. goods, with the results already mentioned—presently U.S.-owned plants abroad falling into the hands of foreign manufacturers; loss of worldwide markets for U.S. products; increased competition in the United States from foreign manufacturers; loss of exports and reduction in the inflow to the United States of income earned abroad, with a consequent loss of jobs in the United States and loss of U.S. tax revenue.

We need not further stress this issue. The facts and opinions of qualified experts have been presented to both congressional tax committees. We only add to theirs the protest of the ITI against the outrageous demand of Mr. Meany for repeal of the foreign tax credit, and our concurrence in the opinion that it would indeed do great harm to the people of the United States.

ADVERSE EFFECTS OF IMMEDIATE TAXATION OF UNDISTRIBUTED INCOME OF FOREIGN CORPORATION

Immediate U.S. taxation of income of foreign corporations before being received by any U.S. taxpayer would penalize principally business in the less-developed countries. Those doing business in the principal industrialized countries would be little affected, assuming that the foreign tax credit is not repealed. This is so because the effective income tax rates in those industrialized countries generally are as high as or higher than the U.S. corporation income tax rate.

On the basis of these facts, as to which there is no dispute, we believe that there should be no further extension of the unconstitutional taxing—under subpart F or otherwise—of U.S. taxpayers on what is not income to them before it is received by or legally made available to them.

PROTEST AGAINST REPEAL OF WHTC PROVISIONS

The ITI protests against the provision of H.R. 10612 which would repeal the Western Hemisphere Trade Corporation provisions of the Internal Revenue Code.

The difficulties in doing business with our Latin American neighbors already are great enough, without this further blow. It seems clear that repeal of the WHTC provisions would seriously diminish our trade with Latin America.

PROTEST AGAINST REPEAL OF INTERNAL REVENUE CODE SECTION 911

In these days it is increasingly difficult for U.S. manufacturers to compete against foreign manufacturers in world markets, on the basis of either technology or marketing ability. Every added burden of U.S. taxes on DISC and foreign business income results in loss of sales and hence reduction in the inflow of income from abroad.

IRC section 911, by exempting from U.S. tax, subject to many limitations, $20,000 of compensation earned abroad by U.S. citizens, makes it somewhat less difficult for U.S. business to get men to work in foreign countries. Its repeal would add to those difficulties.

The ITI therefore urges removal from H.R. 10612 of the provision that would repeal section 911 of the Internal Revenue Code.

CONCLUSION

In conclusion, we repeat the three basic points that we are confident will be observed by this committee:

(*a*) The record shows that business has presented facts that fully support its position regarding U.S. taxes on DISC and foreign trade income—its attackers have not.

(*b*) Increased U.S. taxes on DISC export income and on foreign income will decrease that income, resulting in decreases in the amount of U.S. exports, U.S. jobs, and the inflow of income to the United States.

(*c*) Increased U.S. tax burdens on foreign trade that put U.S. plants abroad in the hands of foreign manufacturers would have disastrous consequences.

The ITI urges the Senate Finance Committee:

1. To substitute, for the provisions of H.R. 10612 that reduce the benefits of DISC, new provisions which would make DISC more attractive to smaller U.S. manufacturers.
2. To reject the demand for repeal of the foreign tax credit.
3. To reject the demand for immediate U.S. taxation of all undistributed foreign income of foreign corporations.
4. To eliminate from H.R. 10612 the provision for repeal of the WHTC provisions.
5. To eliminate from H.R. 10612 the provision for repeal of IRC section 911.

As each provision of H.R. 10612 affecting U.S. taxation of foreign income comes up before your committee for consideration and action,

we urge each of you to ask yourself: Would this increase or decrease employment in the United States? Would this help or worsen our international balance of payments? Would this benefit or harm the economy of our country? And then make your decision on the basis of the facts in the record.

A number of other provisions of H.R. 10612, including some deemed desirable, will be discussed in the supplemental statement the ITI plans to file.

We, therefore, ask the committee for permission to submit for the record a more complete statement of the position of the ITI regarding the taxation of DISC and foreign income. I would ask the committee to file a supplemental statement.

Senator TALMADGE. You may file an additional statement.

[At presstime, June 8, 1976, the material referred to had not been received for the record.]

Senator CURTIS. I want to thank you for your statement. You have a very sympathetic audience this morning. I think we all favor the DISC proposal.

You are thoroughly convinced that the doing away with DISC would lessen the job opportunities in this country.

Mr. SEGHERS. I am absolutely convinced of that, not only from the testimony I have heard from others but from what I have heard from manufacturers countrywide. We hold two, three, four technical meetings a year. Although we don't have a very large attendance, anywhere from 40 to 60, we do have representatives from manufacturing companies throughout the entire country. We get quite a few from the Far West and they are all insistent on the same point, that DISC has helped exports and it has helped employment and repeal of DISC would reduce employment.

Senator CURTIS. Under the House bill, the greater portion of agricultural products are not eligible for DISC benefits. Do you favor that particular part of the House bill?

Mr. SEGHERS. I would not like to speak on a subject on which I am not thoroughly convinced or competent to speak. I have limited our talk to manufacturing. I don't think we have but one or two members that are interested in the agricultural field and none of our technical meetings have included a discussion of agricultural products.

Senator HANSEN. I have no questions.

Senator TALMADGE. Thank you very much. We appreciate your contribution.

The next witness is Mr. Richard N. Thompson, secretary-treasurer and general counsel, Hy-Gain Electronics Corp.

Senator CURTIS. Mr. Thompson is a distinguished citizen of the State of Nebraska, one of our leading attorneys. The Hy-Gain Electronics Corp. is a Lincoln, Nebr., manufacturing concern of which we are very proud. It originated there; that is the base of the company. It has provided jobs there and elsewhere, and we certainly want to welcome you and the other gentleman appearing with you.

Senator TALMADGE. You may proceed. You may file your entire statement for the record and summarize it.

STATEMENT OF RICHARD N. THOMPSON, SECRETARY-TREASURER AND GENERAL COUNSEL, HY-GAIN ELECTRONICS CORP., ACCOMPANIED BY ZOLTAN M. MIHALY, SPECIAL COUNSEL

Mr. THOMPSON. Our statement appears in three parts: my statement, that of our Puerto Rican counsel, Mr. Max Goldman and that of our special tax counsel, Mr. Zoltan Mihaly. Mr. Mihaly is here with me today and I would be pleased to have him give a statement on behalf of our company.

Mr. MIHALY. Mr. Chairman, I am very pleased to appear today before your committee both in my individual capacity and as special counsel to Hy-Gain Electronics Corp. of Nebraska.

The purpose of my appearance is to voice support for the adoption of section 1051 of the tax reform bill passed by the House on December 4, 1975.

I am an attorney engaged in the practice of law in Los Angeles, Calif.

For the last 15 years I served as legal counsel to some U.S. corporations engaged in manufacturing operations in U.S. possessions and particularly in Puerto Rico.

These corporations range from small family owned companies to large publicly held corporations.

As a result of my working on the legal and tax matters of such corporations, I had the opportunity to become intimately acquainted with the industrialization of programs and economic problems of U.S. possessions as well as with the role played by law and taxation in the economic development of the U.S. possessions and particularly Puerto Rico.

The proposed section 1051 of the bill would amend the U.S. tax treatment of corporations operating in Puerto Rico and certain other U.S. possessions.

Presently such tax treatment is provided for in section 931 of the Internal Revenue Code.

Section 931 has been on the books for several decades. It provides in effect if a U.S. corporation operates in certain U.S. possessions, it will be exempt from U.S. corporate taxes provided it meets certain requirements which are specified in such sections.

Typically, corporations operating in U.S. possessions under section 931 consist of corporations manufacturing products in Puerto Rico or some other possession of the United States. The exemption of the profit realized from such business operations from U.S. taxes has been helpful in developing the badly needed industrialization of U.S. possessions.

In Puerto Rico, section 931 constituted an integral part of the so-called industrial bootstrap operation introduced by the Puerto Rican government about 25 years ago. Thanks to section 931 and the tax incentives granted by the Puerto Rican government, many U.S. corporations have established manufacturing operations in Puerto Rico which fact helped to create employment and greatly contributed to the general well-being of the people of Puerto Rico. As a result, the relations between the United States and Puerto Rico are good and it can be reasonably expected that if such program is continued for an-

other 20 years, the great majority of Puerto Ricans will then be ready to have Puerto Rico join the Union, following the examples of Hawaii and Alaska.

Thus, there can be no doubt that the tax treatment provided for by section 931 has been an invaluable tool in assuring that Puerto Rico's industry, economy, standard of living, education, and technical progress, as well as its ties with the mainland of the United States, could be brought to a level that would make a greater integration of Puerto Rico with the mainland of the United States possible. It should be noted, however, that despite the great contributions of section 931 and the entire Puerto Rican industrialization program, the present rate of unemployment in Puerto Rico is still about twice as high as unemployment rate in the mainland of the United States and the per capita income of Puerto Rico is lower than that of any State of the Union.

However, while section 931 proved to be most effective and beneficial, it does have some detrimental side effects which are not helpful either to the economy of Puerto Rico or to the economy of the United States, but, to the contrary, are harmful to both of them.

One such byproduct is that under the present law the income of a section 931 corporation is exempt from U.S. corporate taxes only as long as such income is retained by it. If the section 931 corporation would distribute its profits to the parent corporation, the profits would become fully subject to the 48-percent U.S. corporate tax. Such accumulated profits could be repatriated to the parent corporation on a tax-free basis only if the section 931 corporation would be liquidated by the parent corporation.

As a result of such tax treatment, practically all section 931 corporations retain their profits until their liquidation by the parent corporation. Normally, they deposit such accumulated funds with a bank situated in another possession, such as Guam, or with banks in foreign countries and particularly in Canada. Since under the present law, U.S. corporations can repatriate the funds of the section 931 subsidiary only upon complete liquidation of such subsidiary under section 332 of the IRC, in many cases the U.S. parent corporations felt compelled to completely terminate their Puerto Rican operations just to assure that the repatriated profits will not be subject to U.S. dividends tax, thereby causing sudden, harmful, dislocation of economic resources.

Obviously, these byproducts of section 931 are harmful both to the economy of Puerto Rico and to the economy of the United States. The funds are in a sense "blocked" at the section 931 subsidiary. The law compels such corporations to keep the funds outside the United States. This is detrimental since if the funds could be repatriated to the parent corporation, they could then be used by the parent corporation to create more jobs in this country.

Senator Hansen today talked about the importance of capital formation. It is submitted that this present arrangement which we have is unwise and almost sinful from the point of view of capital formation.

Section 1051 of the bill would resolve this problem by permitting the repatriation of the profits of corporations operating in Puerto

Rico—which would now be known as "section 936 corporations"—on a tax-free basis. The particular provision in this respect is contained in section 1051(f) of the bill. I believe that this change in the law would be very beneficial to our economy since the funds repatriated to the U.S. parent corporation could then be used by it in developing its own business in the United States and thereby creating more employment in this country.

As I mentioned at the beginning of my comments, I and my Los Angeles law firm deal with some 50 corporations operating in Puerto Rico and other possessions through section 931 corporations. I have checked with the management of such corporations and practically all of them have indicated to me that their section 931 subsidiaries would remit their profits to the parent corporation on a current basis if the new law were enacted.

Hy-Gain, on behalf of which I can speak today as its special counsel, would be a good illustration of what is likely to happen depending on whether or not section 1051 of the bill is enacted. If section 1051 is not enacted, Hy-Gain will be compelled, as most other section 931 corporations presently operating in Puerto Rico or other possessions of the United States, to accumulate and retain the Puerto Rican profits at its section 931 corporation. If, on the other hand, section 1051 is enacted, it is most likely that substantially all of the funds not needed in the operations of its section 936 subsidiary would be remitted to Hy-Gain on a current basis. Hy-Gain would then be able to utilize such funds in establishing new manufacturing and marketing facilities in this country.

Thus, the enactment of section 1051 would bring to the United States a substantial amount of capital which, as we all know, is badly needed in order to make new investments and create new job opportunities in this country. It is therefore believed that the enactment of section 1051 of the bill by the Congress would be most beneficial to the economy of our country as a whole and to all of our people.

In addition, the bill would put an end to the practice of investing the accumulated funds of section 931 corporations in various foreign countries. Under the provisions of the bill—paragraph (b) of section 1051 introducing the new section 936 of the IRC—investment income of a section 936 corporation would be exempt from U.S. corporate tax only if it were derived from investments made in the same possession in which the section 936 corporation operates. Thus, a section 936 corporation engaged in manufacturing operations in Puerto Rico would have to remit its accumulated funds to the parent corporation—in which case such funds could be used by the parent corporation to expand its operations in the United States—or such funds would have to be invested in Puerto Rico—in which case they would contribute to the development of the economy of Puerto Rico—but they could not be invested in any foreign country without fully subjecting the income derived from such investments to U.S. tax.

Mr. Chairman, the trouble with most proposed legislation is that it is good for some people, but bad for others. A proposed new measure could be beneficial to the United States, but detrimental to Puerto Rico and other possessions, or vice versa. In this case, we have here, fortunately, a proposal which seems to be good for all parties con-

cerned. Its adoption can significantly contribute to our own economy since it will result in an influx of needed capital. It is also beneficial to Puerto Rico and other U.S. possessions involved since it will continue the substance of the tax incentive program and will force the investment of funds generated by the tax exempt manufacturing operation in the particular U.S. possession or in the United States.

For these reasons, I believe that the proposed provision will serve as an effective weapon against those who would like to convert Puerto Rico into another Cuba.

In view of these facts, I believe that the enactment of section 1051 of the bill is in the best interest of this country, voice my support for its adoption and respectfully request that your committee pass such measures.

Senator TALMADGE. Thank you, sir.

Senator Curtis.

Senator CURTIS. I want to say that I have considerable support for the view you are presenting here. I understand that the staff and the Treasury support this part of the House bill.

Mr. Thompson, tell us briefly about Hy-Gain's operation in Puerto Rico and what it has meant to its economy.

Mr. THOMPSON. I will be happy to.

We established a plant in Puerto Rico something over a year ago to manufacture two-way citizen-band radios. Most of these two-way radios which have become very popular have been manufactured in the Far East. We were able to economically manufacture them in Puerto Rico.

We have established now five plants in Puerto Rico and employ some 500 people down there.

Senator CURTIS. You anticipate employment of how many individuals?

Mr. THOMPSON. Over 1,000.

Senator CURTIS. Has that in any way lessened job opportunities in the United States?

Mr. THOMPSON. Not at all. It has enhanced them.

Senator CURTIS. How old is the Hy-Gain Co.?

Mr. THOMPSON. It is about 20 years old, Senator.

Senator CURTIS. What was its original product?

Mr. THOMPSON. Antennas.

Senator CURTIS. Has this additional business activity, which responded to the policy of the United States of alleviating the very sad unemployment situation in Puerto Rico, brought you more antenna business in this country?

Mr. THOMPSON. It has, and our business has gone up as a result.

Senator CURTIS. Am I correct that this problem is the same one with respect to which the Puerto Rican Commissioner testified to this morning?

Mr. THOMPSON. Exactly.

Senator CURTIS. Do you support his position?

Mr. THOMPSON. We do, indeed.

Senator CURTIS. I understand that the unemployment rate is as high as 30 percent in some parts of Puerto Rico.

Mr. THOMPSON. That is correct.

Senator CURTIS. Have your plants been established in areas of high unemployment?

Mr. THOMPSON. They have been, so we have made a material contribution to those areas in Puerto Rico where our plants are located.

Senator CURTIS. I believe I read in your statement that, before they get the jobs, 65 percent of these people are on food stamps?

Mr. THOMPSON. That is true, and it is an alarming statistic.

Senator CURTIS. That is an indication of the extra burden placed upon other Government programs. These people are desperately in need of employment.

Our time is limited, but I do want to say that your statement here is an excellent one. It is certainly of interest not only to the employment of people in Puerto Rico but also the continental portion of our country.

Senator TALMADGE. Thank you very much, gentleman, for your contribution.

[The prepared statements of Messrs. Thompson, Mihaly, and Goldman follow:]

STATEMENT OF RICHARD N. THOMPSON

Gentleman: This statement is submitted in support of the above provision of the Tax Reform Act of 1975, as to which public hearings will be held before your Committee beginning Monday, March 29, 1976.

Hy-Gain Electronics Corporation is a Lincoln, Nebraska based manufacturer and distributor of personal communications equipment, including Citizens Band transceiver radios and antenna systems. Hy-Gain was organized in 1949 and until late 1974 its sole manufacturing facilities were located in Lincoln, Nebraska.

In late 1974, recognizing the potential market for Citizens Band two-way radios and scanner monitor receivers, Hy-Gain established a Puerto Rico subsidiary in accordance with the provisions of Section 931 of the Internal Revenue Code. In February of 1975 it occupied its first manufacturing plant facility in Naguabo, Puerto Rico and there began the manufacture and assembling of scanner monitor receivers. In the summer of 1975, Hy-Gain commenced the manufacture and assembling of Citizens Band two-way radios in Naguabo, Puerto Rico.

At present, Hy-Gain's Puerto Rico subsidiary operates five manufacturing plants in Naguabo, Puerto Rico and recently entered into a lease contract for an 86,000 square foot plant in Humacao, Puerto Rico, a distance of about twenty miles from Naguabo. The Humacao plant will be fully operational by the end of calendar 1976, with initial operations beginning in May or June of 1976.

Hy-Gain's Puerto Rican subsidiary currently employs approximately 400 people, and when the Humacao plant is fully operational, it is expected that its employment in Puerto Rico will increase to approximately 1,200. Hy-Gain's Puerto Rican plants have been located in Puerto Rico communities where the level of unemployment ranges between 25 and 30 percent.

The addition of the Puerto Rico plants has not resulted in any decrease in employment in Lincoln, Nebraska. To the contrary, the increased level of production of Citizens Band radios and scanner monitor receivers in Puerto Rico has permitted the Lincoln plant to increase its production of antenna systems for this equipment.

Additional expansion of plant operations in Lincoln, Nebraska and elsewhere in the United States is required to meet the growth of Hy-Gain's business. Adoption of the new Section 936 would permit the recycling of earnings of the Puerto Rico subsidiary into the United States economy on a current basis, thereby enabling Hy-Gain to expand its United States base of operations which, in turn, would create additional employment and generate additional individual and corporate taxable income to the United States Treasury and other taxing authorities.

We believe that Hy-Gain has made an important contribution to the depressed Puerto Rican economy by bringing a new industry to Puerto Rico and creating substantial new payrolls in an economically depressed section of that island. We

have been advised that over 65 percent of the population in the area of our Puerto Rico plants receive benefits under the United States food stamp program. We have been most pleased with the productiveness, employer loyalty, lack of attrition and absenteeism and strong work ethic of our Puerto Rican employees.

As you are well aware under present provisions of the United States Internal Revenue Code, accumulated profits of Section 931 "possession corporations" operating in Puerto Rico are locked into various tax free investments and are not recycled productively into the United States economy because of the tax penalty currently applicable. Thus, while Section 931 has fostered economic development in Puerto Rico, it has not created parallel benefits to the United States economy.

We strongly believe that adoption of Section 936 would further enhance economic development in the Commonwealth of Puerto Rico while also funneling accumulated earnings of the Puerto Rican subsidiary back into the capital-short United States economy, thereby creating more jobs and tax revenues domestically.

The ability of Hy-Gain to economically manufacture and assemble its communications products in Puerto Rico has lessened its dependence upon purchase of finished good and components from Far Eastern countries, thereby making a favorable contribution to the U.S. balance of payments.

We feel that Hy-Gain Electronics Corporation is a small company which has enjoyed considerable growth with the assistance of the tax and other incentives afforded by the Commonwealth of Puerto Rico and Section 931. We, likewise, feel that its further growth within the United States would be substantially enhanced by the adoption of Section 936.

We strongly support this legislation and respectfully encourage its passage at an early date.

Statement of Zoltan M. Mihaly

Mr. Chairman, I am very honored to have the privilege of appearing before your Committee both in my individual capacity and as special counsel to Hy-Gain Electronics Corporation of Nebraska. The purpose of my appearance is to voice support for the adoption of Section 1051 of the Tax Reform Bill passed by the House of Representatives on December 4, 1975. Such Bill is also known as H.R. 10612, and I will hereafter refer to it simply as the "Bill."

I am an attorney engaged in the practice of law in Los Angeles, California. For the last 15 years, I served as legal counsel to some 50 U.S. corporations engaged in manufacturing operations in U.S. possessions and particularly in Puerto Rico. These corporations range from small, family-owned, companies, to large, publicly-held, corporations. As a result of my working on the legal and tax matters of such corporations, I had the opportunity to become intimately acquainted with the industrialization programs and economic problems of U.S. possessions as well as with the role played by law and taxation in the economic development of the U.S. possessions and particularly in Puerto Rico. It was felt that, in view of such experience, it was appropriate for me to appear before your Committee, both in my personal capacity and also as special counsel to Hy-Gain, to comment on the important piece of legislation presently before you.

The proposed Section 1051 of the Bill would amend the U.S. tax treatment of corporations operating in Puerto Rico. Presently, such tax treatment is provided for in Section 931 of the IRC. Section 931 has been on the books for several decades. It provides, in effect, that if a U.S. corporation operates in certain U.S. possessions, it will be exempt from U.S. corporate taxes provided it meets the requirements specified in Section 931. Typically, corporations operating in U.S. possessions under Section 931 consist of corporations manufacturing products in Puerto Rico or some other possession of the United States. The exemption of the profit realized from such business operations from U.S. taxes has been helpful in developing the badly needed industrialization of U.S. possessions.

In Puerto Rico, Section 931 constituted an integral part of the so-called industrial bootstrap operation introduced by the Puerto Rican Government about 25 years ago. Thanks to Section 931 and the tax incentives granted by the Puerto Rican Government, many U.S. corporations have established manufacturing operations in Puerto Rico which fact helped to create employment and greatly contributed to the general well-being of the people of Puerto Rico. As a result, the relations between the United States and Puerto Rico are good and

it can be reasonably expected that if such program is continued for another 20 years, the great majority of Puerto Ricans will then be ready to have Puerto Rico join the Union, following the examples of Hawaii and Alaska.

Thus, there can be no doubt that the tax treatment provided for by Section 931 has been an invaluable tool in assuring that Puerto Rico's industry, economy, standard of living, education, and technical progress, as well as its ties with the Mainland of the United States, could be brought to a level that would make a greater integration of Puerto Rico with the Mainland of the United States possible. It should be noted, however, that despite the great contributions of Section 931 and the entire Puerto Rican industrialization program, the present rate of employment in Puerto Rico is still about twice as high as the unemployment rate in the Mainland of the United States and the per-capita income of Puerto Rico is lower than that of any State of the Union.

However, while Section 931 proved to be most effective and beneficial, it does have some detrimental side effects which are not helpful either to the economy of Puerto Rico or to the economy of the United States, but to the contrary, are harmful to both of them.

One such bi-product is that under the present law the income of a section 931 corporation is exempt from U.S. corporate taxes only as long as such income is retained by it. If the section 931 corporation would distribute its profits to the parent corporation, the profits would become fully subject to the 48% U.S. corporate tax. Such accumulated profits could be repatriated to the parent corporation on a tax-free basis only if the section 931 corporation would be liquidated by the parent corporation.

As a result of such tax treatment, practically all section 931 corporations retain their profits until their liquidation by the parent corporation. Normally, they deposit such accumulated funds with a bank situated in another possession, such as Guam, or with banks in foreign countries and particularly in Canada. Since under the present law, U.S. corporations can repatriate the funds of the section 931 subsidiary only upon complete liquidation of such subsidiary under Section 332 of the IRC, in many cases the U.S. parent corporations felt compelled to completely terminate their Puerto Rican operations just to assure that the repatriated profits will not be subject to U.S. dividends tax, thereby causing sudden, harmful, dislocation of economic resources.

Obviously, these bi-products of Section 931 are harmful both to the economy of Puerto Rico and to the economy of the United States. The funds are in a sense "blocked" at the section 931 subsidiary. The law compels such corporations to keep the funds outside the United States. This is detrimental since if the funds could be repatriated to the parent corporation, they could then be used by the parent corporation to create more jobs in this country.

Section 1051 of the Bill would resolve this problem by permitting the repatriation of the profits of corporations operating in Puerto Rico (which would now be known as "section 936 corporations") on a tax-free basis. The particular provision in this respect is contained in Section 1051(f) of the Bill. I believe that this change in the law would be very beneficial to our economy since the funds repatriated to the U.S. parent corporation could then be used by it in developing its own business in the United States and thereby creating more employment in this country.

As I mentioned at the beginning of my comments, I and my Los Angeles law firm deal with some 50 corporations operating in Puerto Rico and other possessions through section 931 corporation. I have checked with the management of such corporations and practically all of them have indicated to me that their section 931 subsidiaries would remit their profits to the parent corporation on a current basis if the new law were enacted. Hy-Gain, on behalf of which I can speak today as its special counsel, would be a good illustration of what is likely to happen depending on whether or not Section 1051 of the Bill is enacted. If Section 1051 is not enacted, Hy-Gain will be compelled, as most other section 931 corporations presently operating in Puerto Rico or other possessions of the United States, to accumulate and retain the Puerto Rican profits at its section 931 corporation. If, on the other hand, Section 1051 is enacted, it is most likely that substantially all of the funds not needed in the operations of its section 936 subsidiary would be remitted to Hy-Gain on a current basis. Hy-Gain would then be able to utilize such funds in establishing new manufacturing and marketing facilities in ths country.

Thus, the enactment of Section 1051 would bring to the United States a substantial amount of capital which, as we all know, is badly needed in order to make new investments and create new job opportunities in this country. It is therefore believed that the enactment of Section 1051 of the Bill by the Congress would be most beneficial to the economy of our country as a whole and to all of our people.

In addition, the Bill would put an end to the practice of investing the accumulated funds of Section 931 corporations in various foreign countries. Under the provisions of the Bill (paragraph (b) of Section 1051 introducing the new Section 936 of the IRC), investment income of a section 936 corporation would be exempt from U.S. corporate tax only if it were derived from investments made in the same possession in which the section 936 corporation operates. Thus, a section 936 corporation engaged in manufacturing operations in Puerto Rico would have to remit its accumulated funds to the parent corporation (in which case such funds could be used by the parent corporation to expand its operations in the United States) or such funds would have to be invested in Puerto Rico (in which case they would contribute to the development of the economy of Puerto Rico), but they could not be invested in any foreign country without fully subjecting the income derived from such investments to U.S. tax.

Mr. Chairman, the trouble with most proposed legislation is that it is good for some people, but bad for others. A proposed new measure could be beneficial to the United Staes, but detrimental to Puerto Rico and other possessions, or vice versa. In this case, we have here, fortunately, a proposal which seems to be good for all parties concerned. Its adoption can significantly contribute to our own economy since it will result in an influx of needed capital. It is also beneficial to Puerto Rico and other U.S. possessions involved since it will continue the substance of the tax incentive program and will force the investment of funds generated by the tax exempt manufacturing operation in the particular U.S. possession or in the United States.

For these reasons, I believe that the proposed provision will serve as an effective weapon against those who would like to convert Puerto Rico into another Cuba.

In view of these facts, I believe that the enactment of Section 1051 of the Bill is in the best interest of this country, voice my support for its adoption and respectfully that your Committee pass such measure.

The Importance of Maintaining the Effectiveness of the Puerto Rico Industrial Development Program

(By Max Goldman)

Numerous U.S. enterprises and individuals have been attracted to Puerto Rico to set up manufacturing plants there, as the result of incentives offered under the Industrial Development Program. The principal incentives offered have been exemption from Puerto Rico Income Tax for a specified number of years depending upon the location of the plant. The effectiveness of this incentive has depended principally upon the fact that Puerto Rico organized corporations are not subject to U.S. Income Tax on income derived from sources in Puerto Rico, and U.S. domestic corporations operating in conformity with the provisions of Section 931 of the U.S. I.R.C. and its predecessor, Section 251 of the 1939 Code, are also not subject to U.S. tax on income from sources in Puerto Rico. A grant of tax exemption from Puerto Rico taxes is of trivial significance without a corresponding exclusion from U.S. taxation. The enactment of the proposed Section 936 to replace the current I.R.C. Section 931 would enable continuance of the Puerto Rico Industrialization Program.

In the 25 years since 1948, as a result of its industrial development program, Puerto Rico has made substantial strides in converting its economy from one which was largely agricultural, with a low per-capita income, to a more industrialized economy with a per-capita income which, while lower than that of any State of the Union, is higher than that of the respective Latin American countries. However, even with this substantial measure of progress, there is still an unemployment rate in excess of 12 percent in Puerto Rico. This is a factor which has contributed to the extensive migration of Puerto Ricans to various

localities on the Mainland of the United States, particularly eastern seaboard cities.

The difficulties which Puerto Rico has confronted in its efforts to industrialize and create jobs must be recognized. Puerto Rico is an island located 900 miles from Miami and 1300 miles from New York. Except for the coastal area, its terrain is principally hilly or mountainous. It does not possess any extensive store of natural resources. To the extent that it possesses mineral resources, it will require massive investment and a number of years of development before they can contribute materially to the economy of Puerto Rico. Its principal natural resource is a mild and semi-tropical climate. Industries established in Puerto Rico are confronted with the necessity of having raw materials shipped in from the Mainland and of having the finished product shipped back to the Mainland or foreign countries. Thus, distance from potential sources of raw materials and markets for finished products inevitably increase the cost of production. The tax exemption incentive offered under the Industrialization Program has been a principal factor in inducing Mainland industries to establish plants in Puerto Rico. It should be noted that, throught its Industrial Development Program, Puerto Rico has consistently pursued a policy of barring from the benefits of tax exemption, "runaway industries", that is, industries which close their plants in the States to avail themselves of benefits in Puerto Rico.

It may be noted that prior to the Industrialization Program in 1948, the Government of Puerto Rico made its own efforts to promote industrialization by establishment of industries financed by the government. Under this program, there were established a cement plant, a glass plant, a paper board plant and a shoe plant, among others. However, the limitations of this type of industrial development effort were early recognized, particularly with respect to products such as shoes. It became evident that any one plant producing given styles and sizes of shoes would be competing with a large variety of styles from Mainland and foreign sources and the possible percentage of the market for any one local Puerto Rico shoe plant would be negligible, so that its prospects of survival were problematical. It was thus recognized that the problem of marketing could not be solved except by those who already had the know-how and access to the market. In like fashion, it was learned that the acquisition of manufacturing know-how was a very expensive matter, in absence of management which already had experience in the field. It was in the light of recognition of such factors that the Government of Puerto Rico determined that the most fruitful means of industrialization was to offer incentives to induce those who already had the manufacturing and marketing know-how and capital to establish plants in Puerto Rico.

The industrialization program has yielded fruitful results in creating jobs, skills and a reservoir of technical and managerial personnel. However, it has been beset with major problems.

One of the major problems now faced by the economy of Puerto Rico, is the escalation of wages, particularly in the labor intensive industries. In the face of increasing wage rates, these industries which have been the backbone of the Industrialization Program up to the present, are particularly vulnerable, at this time, to the competition of lower wage areas in other parts of the world. Thus, the Caribbean countries, such as Haiti and Santo Domingo, Central American countries such as Costa Rica, and South American countries, have been emerging as strong competitors in such fields as needlework. Realistically, it must be recognized that the obligations of the United States to these countries to foster their development will make remote the possibility of tariff or quota limitations on the output by these countries.

Another source of serious problems for the economy of Puerto Rico has been the precipitate rise in the price of crude oil joined with weaking demand and falling prices for certain petrochemical derivatives produced in Puerto Rico. As the result of this situation, the pioneer petrochemical complex in Puerto Rico, Commonwealth Oil Refining Company, has suffered massive losses in the past year, the other refineries have suffered losses, and Fibers International, a Phillips Petroleum affiliate, dedicated to the manufacture of polyester staple from petrochemical intermediate products, has ceased operations.

The uncertain state of the economy, combined with wage increases and the oil crisis, has severely affected the economy of Puerto Rico. Numerous plant closings have taken place during the past two years. The construction industry is in a state of crisis. The current unemployment rate is over double the Mainland

unemployment rate. In the context of these problems, the Industrial Incentives Program becomes of increased imporatnce for the creation of jobs.

The fact that Puerto Rico is an island out in the Atlantic Ocean, with a population density which is one of the highest in the world (about 660 to the sq. mile, comparable to that of the Netherlands), must not be lost sight of. It would be a mistake to draw any parallels between Puerto Rico and the Virgin Islands or Hawaii, to both of which Section 936 would not be applicable. In the Virgin Islands, we are dealing with a population of 80,000 persons, In contrast with a population of nearly 3 million in Puerto Rico. The tourist industry is the principal industry in the Islands and represents a vastly larger proportion of the gross income of these Islands than that industry represents for Puerto Rico. In the case of Hawaii, two major factors have served to differentiate it from the situation of Puerto Rico over the years. The first one is that direct federal expenditure, principally with respect to military and naval installations and personnel, is a much larger percentage of the gross income of Hawaii than such expenditures represent for Puerto Rico. The second is that Hawaii, with large areas of flat land has a more highly mechanized and developed agriculture than Puerto Rico. Accordingly, Puerto Rico must be dealt with on a different basis from these Islands.

Puerto Rico's isolated situation has the effect of depriving its economy of the resilience which the Mainland economy enjoys as a result of size and highly complex geographical and industrial interrelations. To the limited extent that Puerto Rico had been able to achieve some integrtaion of industry, a measure of resilience has resulted. This is demonstrated in the needlework and knitwear industries. In the last 5 years, there has occurred in the Mainland apparel market, major changes in female styles. The popularity of "hot pants" resulted in a growth of the pantyhose industry and a decline in such industries as conventional hosiery and slips. The popularity of the pantsuits has had similar effect. A segment of the female population no longer regards the brassiere as an article of attire. All of these changes have had effects on employment and production in Puerto Rico. Thus, cutbacks and loss of jobs in the brassiere and slip industries among others, resulted. However, because of the presence of a trained needlework labor pool, industries devoted to the products of rising popularity, such as hot pants, pantsuits and other items of ladies sportswear, came to take their place. But even this limited measure of "moving stability" may be imperiled if labor intensive industries, such as the needlework industry are redirected to other areas of the world by a radical change of their current tax status in Puerto Rico.

The social effects of an arrest of the Industrial Development Program of Puerto Rico must be given consideration. At the present time, theer is already evident a reverse migration of Puerto Ricans who have acquired skills in the States and who desire to return to Puerto Rico because of reasons of climate or family. To the extent that industrial development in Puerto Rico continues, the migration of unskilled persons from Puerto Rico to the Mainland cities will be arrested and the reverse migration from the Mainland encouraged. A curtailment of industralization in Pureto Rico can only have the effect of accelerating migration from the Island to the Mainland. To the extent that the problems of Puerto Ricans can be solved in Puerto Rico, this will decrease presures on the resources of the major Mainland cities and the Federal government. In absence of incentives for operating in Pureto Rico, the capacity of some Mainland industries with subsidiary operations in Puerto Rico to meet foreign competition would be substantially impaired.

Senator TALMADGE. Our next witness is Mr. Foster Parker, president, Brown & Root, accompanied by Professor Michael E. Conroy of the University of Texas at Austin.

STATEMENT OF FOSTER PARKER, PRESIDENT, BROWN & ROOT, ACCOMPANIED BY PROF. MICHAEL E. CONROY, UNIVERSITY OF TEXAS AT AUSTIN

Mr. ~~PARKER.~~ Mr. Chairman and members of the committee, I am Foster Parker, president of Brown & Root, Inc., an international

construction company. I am appearing with respect to the proposed repeal of the provisions excluding certain income earned abroad by U.S. citizens from tax. This provision is found in section 1011 of the Tax Reform Bill of 1975. I would like to direct my remarks solely to this exclusion's effect on U.S. construction workers overseas. Appearing with me is Dr. Michael Conroy, professor of economics of the University of Texas at Austin. He is a specialist in international trade and has studied this matter extensively. While my remarks shall be brief, I request permission to submit additional data for the record. I also have with me a chart which I shall use for illustration.

The so-called "earned income exclusion" contained in section 911 of the tax law was in substance first enacted in 1926 when, using the language of the House committee report of that year, this provision was inserted " * * * to put all Americans who are working abroad in a position of equality with their competitors * * * "

Since then this provision has been reviewed at least nine times by this committee with frequent changes, but a basic premise has always been that some exclusion of the income of U.S. citizens residing abroad should be retained to preserve this "equality" between Americans and their foreign competitors.

The provision has been criticized frequently as providing an undue economic advantage for foreign residency. I doubt that this is true in many cases, but that is not the principle point of my appearing before you. I am concerned about the action of the House of Representatives in repealing this tax exclusion for the wages of Americans who are working on the construction of a permanent facility abroad. The reasons for my concern may be briefly summarized as follows:

1. U.S. construction companies who construct permanent facilities abroad usually get the jobs on the basis of competitive bidding between one or more American companies and their foreign competitors, such as the German, Japanese, or French companies. In other words, the low bidder usually gets the job.

2. No industrial nation in the world except the United States (the only other nation being the Philippines) taxes its citizens who are working in a foreign country.

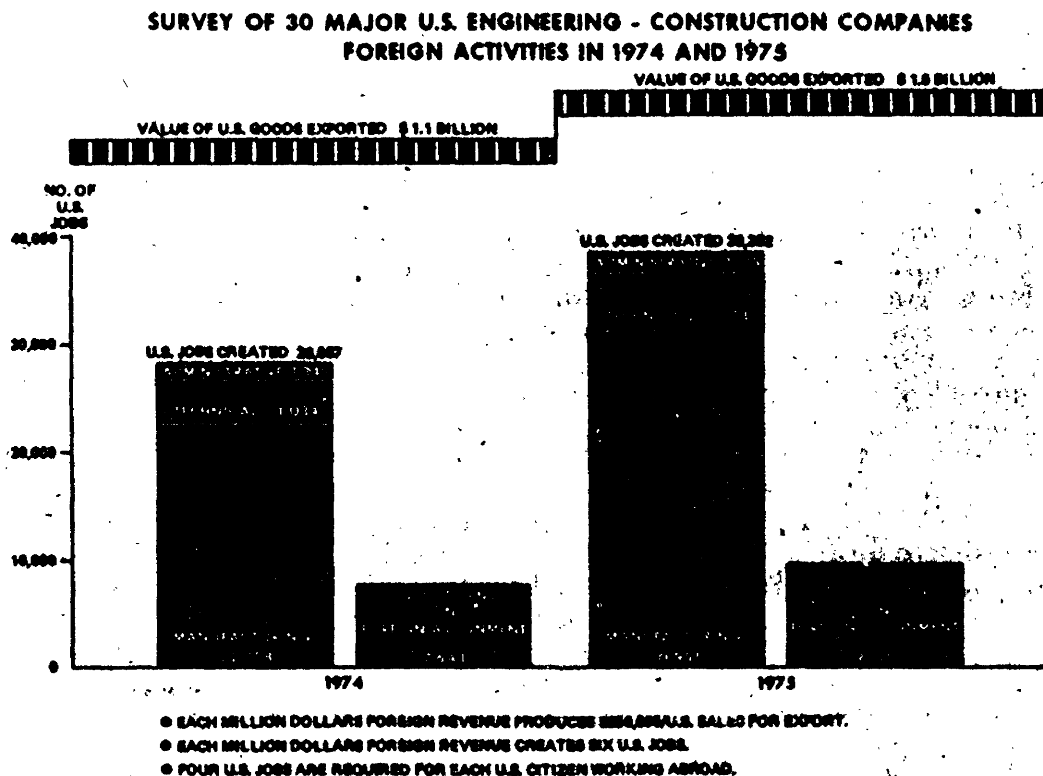
3. Therefore, if a U.S. company, utilizing American skilled labor for construction abroad, must pay these Americans enough to induce them to work overseas plus an additional amount so that they can pay income taxes that they don't pay now, the labor cost to the U.S. companies may very well increase to the point where our bids would not be competitive with the bids of companies utilizing foreign skilled labor.

4. I would like to point out in addition that some foreign countries consider the domestic benefits flowing from the sale of materials and equipment to their international construction companies so important that they directly subsidize the bids of these companies or assume an ownership position. Of course, we receive no such U.S. subsidies.

The results arising from the loss of these international construction contracts may be quickly demonstrated by the chart that is on the easel.

This information is based on a survey by an independent certified public accounting firm of 30 major U.S. construction companies which had foreign activities in 1974 and 1975.

[The chart referred to above follows:]



Senator DOLE. You are speaking about subsidies. Do you have any particular countries in mind where they subsidize your competitors?

Mr. PARKER. Most European countries do. I can give you a recent example. We were bidding for an airport, a large contract in a Middle Eastern country. We were one of the finalists along with a German manufacturer. Because the specifications were so indefinite we were unable to give a fixed-price bid. Our German competitor could not either. Finally, the German competitor gave a fixed price because his Government guaranteed him his company would suffer no loss. We could not give such a guarantee.

Senator DOLE. Are there a number of white-collar executives in the construction industry who would benefit from the earned income exclusion or is this something for Brown and Root?

Mr. PARKER. This is primarily for the men who execute the work in the field, the superintendents, the foremen, the lead craftsmen. The white-collar people who do the planning, the estimating in our company are in Houston, Tex., and for other large contractors they would be located in the home offices of those companies where they would, of course, be subject to local U.S. income taxes. We have 2,200

people who have this exemption now. Eight of them are officers, which I would put in the white-collar executive class.

Senator DOLE. If we accept your recommendation, you are in effect assuring this committee that in a year or two we won't discover the earned income provision is for the benefit of your executives and others in similar circumstances?

Mr. PARKER. No, sir, we have no plans to change our mode of operation. The executives must remain in the States. It is the men who execute the jobs that I am concerned about.

As the chart illustrates, in 1974 there were approximately 7,600 employees abroad of these 30 companies and about 9,500 in 1975. More importantly from the standpoint of U.S. jobs is that the foreign projects created approximately 28,000 additional jobs in the United States in 1974 and 38,000 in 1975—a ratio of about four workers in the United States for each American working abroad. This is primarily because American companies working on these projects generally order only American materials and equipment. If a foreign construction company gets the job, it usually gets its materials and equipment from its home country.

May I emphasize that we are only suggesting insofar as the construction companies are concerned that this rule be maintained for the construction of a permanent facility located abroad. In other words, in order to build a facility we must go abroad; we can't build harbors, airports, and the like in the United States and then move them to the foreign country. Consequently, it is not a question of exporting jobs from the United States by working abroad, it is a question of maintaining both the jobs of the U.S. construction workers abroad and the jobs of those in the United States who back them up.

The importance of maintaining the present concept may be graphically illustrated. The value of United States goods exported to the foreign projects increased from $1.1 billion in 1974 to $1.6 billion in 1975. Over the years, this has been of tremendous assistance to our balance of payments. When you consider that our basic balance of payment surplus for 1975 was $1.4 billion and this was the first surplus year since the Department of Commerce started keeping such records in 1960, you can readily see the importance of construction exports to our economy.

It is frequently argued that this exclusion should be repealed because the foreign tax credit to the individual takes care of any double taxation. However, in most of the countries in which American companies are now working, the foreign taxes that are eligible for the credit would not begin to give equality. In addition, there is an increasing tendency on the part of foreign countries to utilize the value added tax and similar devices which are not eligible for the foreign tax credit. Therefore, the availability of the foreign tax credit helps, but does not go nearly far enough to achieve tax equality in the international construction area.

I might add in this regard that we support the concept in the House bill denying the credit for taxes paid on the amounts excluded from tax under this provision.

The United States enjoys a competitive advantage over foreign countries at this time in the production of goods for export if those

goods are clearly associated with products and services which require large amounts of highly skilled labor. This advantage is available to us because we enjoy a relatively greater abundance of highly skilled persons in professional, technical, and managerial occupations. The international construction industry is an industry which uses abroad these types of highly skilled personnel and products. The American personnel employed overseas are predominantly engineers and skilled craftsmen working in the design, supervision, and execution of construction projects. They in turn are the ones who ordered the American products which resulted in some 40,000 additional American jobs in 1975.

To jeopardize that competitive advantage by reducing U.S. competitiveness in the industry through the elimination of the foreign source earned income exclusion is to damage U.S. export prospects in one of the most important areas of our economy.

This is especially hard to understand when a very recent study of the National Science Foundation transmitted to Congress by the President described in great detail how this Nation was rapidly falling behind other industrial nations such as Germany, in research, patents, engineers, and technological improvements.

It is pertinent to note that the Ways and Means Committee report estimated that only about $55 million of revenue would be involved in repeal of all of section 911. Certainly the exclusion of the wages of the construction workers abroad could represent only a small part of that, yet this is the vital amount in our opinion to get the foreign contracts and thereby preserve the jobs in the United States.

In summary, many recent analyses of international trade patterns suggest that the U.S. international construction industry should be viewed as an industry which presently is representative of the leading edge of American competitive advantage within the changing world economy, which we must persevere to keep it so. The U.S. competitive advantage in international construction is our ability to design and manage the development of essentially "one-of-a-kind" construction projects that must be located abroad. These projects in turn utilize U.S. products. This is completely different from the "product cycle" of a manufacturing business which some have argued should be done in the United States. In short, U.S. firms in the international construction industry possess a competitive ability internationally which is less likely to be lost than our mass-production superiority unless, that is, U.S. tax policy makes highly skilled U.S. labor more costly overseas by imposing greater taxes than must be paid by employees of competing firms from other nations. Gentlemen, for the welfare of our Nation, Congress should not impose this tax barrier.

Senator TALMADGE. You stated approximately 40,000 jobs were created in the United States due to approximately 10,000 construction workers overseas. Could you tell this committee in what industries these 40,000 jobs are concentrated?

Mr. PARKER. They are primarily in the manufacturing industry where sophisticated equipment is made. One industry would include manufacturers of construction equipment like Caterpillar, Manitowoc, International Harvester, Insley, Euclid, et cetera.

Others would include manufacturers who make complicated equipment going into the facilities themselves, like compressors, pumps, engines, valves, and sophisticated instrumentation in computer-controlled equipment. Those are manufactured by many companies scattered throughout the United States.

Senator TALMADGE. If these construction workers were not engaged in work in foreign countries, these sales very likely would not be made.

Mr. PARKER. That is correct. If a U.S. contractor gets the job he will buy his equipment in the United States.

Senator TALMADGE. Senator Curtis.

Senator CURTIS. Will the U.S. contractor also purchase his follow-through parts in this country?

Mr. PARKER. Very much so.

Senator CURTIS. When we establish one business in a foreign country, it is conducive to other business flowing to that foreign country. This is because the channels of finance are set up so it is easier for that country to come back to the same source for additional related, and sometimes unrelated, items.

Mr. PARKER. That is a very good point. Once a plant is built out of American equipment, replacement items and expansion items will come from the United States first.

Senator CURTIS. I have had occasion to talk to some of our leading contractors in the country.

Mr. PARKER. You have an outstanding one in your area of the country.

Senator CURTIS. He is one of our leading citizens and a great benefactor in the State. I certainly concur with your statement here.

If, as the House of Representatives has proposed, we repeal the provisions of existing law with respect to income earned abroad, would that hamper your ability to compete with contractors in the other industrialized countries?

Mr. PARKER. Very much so, because in order to induce a man to go overseas, sometimes in very difficult areas in which to live, you have to pay him a premium to start with. Then he has a tax exemption. If that exemption is taken away from him, I think we would personally have to double those salaries. That puts us in a position where we are no longer competitive with the Japanese, the Germans and the French.

The average income of the person I am talking about, the great bulk of the 2,200 in our company, is between $20,000 and $25,000 a year. It is the men, the foremen, the superintendents, the project men who are actually out there getting the work done, supervising the work of the local employees who are the citizens of the host country that we employ or hire locally.

Senator CURTIS. The repeal of this provision would not in the long run increase the revenues of the Treasury of the United States at all, would it?

Mr. PARKER. In the long run it would be very expensive.

Senator CURTIS. This is because the health and prosperity of our American contractors would be adversely affected to the extent they lost contracts to foreign competitors.

Mr. PARKER. That is very true.

Senator CURTIS. Also, revenues would be decreased by the loss of jobs in this country, as you have mentioned.

Mr. PARKER. That is correct.

Senator TALMADGE. Thank you very much for a very impressive presentation, Mr. Parker.

[Schedule A to Mr. Parker's prepared testimony is as follows:]

SCHEDULE A

SURVEY[1] OF 30 MAJOR U.S. ENGINEERING-CONSTRUCTION COMPANIES—FOREIGN ACTIVITIES IN 1974 AND 1975

	1974 (actual)	1975 (estimated)
1. Value of U.S. goods purchased and exported to foreign projects	$1,112,571,000	$1,613,273,000
2. Number of U.S. jobs created due to foreign projects:		
A. Manufacturing industry	22,708	30,951
B. Design engineers	4,034	5,513
C. Administrative and other	1,345	1,838
Total	28,087	38,302
3. Number of U.S. citizens on foreign assignment	7,643	9,533

[1] Prepared by independent certified public accounting firm.

Senator TALMADGE. The next and final witness for today is Dr. Robert B. Stobaugh, professor of business administration, Harvard Business School.

Mr. Stobaugh, your entire statement may be inserted in the record and you may summarize it.

STATEMENT OF PROF. ROBERT B. STOBAUGH, HARVARD BUSINESS SCHOOL

Dr. STOBAUGH. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today.

For some time there have been proposals in Congress to increase substantially the U.S. taxes on U.S.-owned operations abroad. One of these proposals is to place a U.S. income tax on the unremitted earnings of foreign corporations owned by U.S.-based companies (that is, on those earnings retained by a subsidiary and thus not paid as dividends). This is the proposal that often is referred to as the "elimination of the deferral of U.S. income tax on foreign earnings."

If the United States were to place a tax on unremitted earnings, then U.S.-owned foreign corporations (that is, subsidiaries) operating in countries with lower tax rates than the United States would be placed at a competitive disadvantage vis-a-vis their foreign competitors, which would continue to pay only local taxes on their retained earnings (that is, earnings not paid as dividends). Of course, those U.S.-owned foreign subsidiaries operating in countries with tax rates equal to or higher than the United States would not be affected.

In a report, which with your permission I would like to have inserted in the record, I and a group of colleagues present quantitative estimates of the effect that the legislation might have on selected aspects of the U.S. economy, principally on U.S. taxes collected and on the U.S. balance-of-payments.

Senator TALMADGE. That report will be included in the record.

Dr. STOBAUGH. We consider only manufacturing operations. We make these estimates by taking into account the foreign tax rates and the probable changes in competitive positions of U.S.-owned

foreign subsidiaries over time. These estimates, although based on the most relevant data and concepts that we could find, still incorporate quite a bit of judgment. Good data are hard to come by; but even when good data are available, no economic model exists to give an unequivocal answer. [This statement includes such economic models as those in which national income and the distribution of this income between labor and capital are determined by an equation with two homogeneous variables—labor and capital—and which are based on such unrealistic assumptions as full employment, perfect competition, a relatively large displacement of domestic investment by any foreign investment, and the lack of any effect of U.S. profit rates on flows of portfolio capital into and out of the United States. I have prepared a critique of one such model and with your permission would like to have it inserted in the record.]

Senator TALMADGE. Without objection, it will be inserted.

Dr. STOBAUGH. To be sure, if the U.S. Government were to increase the amount of taxes collected from the foreign operations of American companies, U.S. Government revenues and the U.S. balance-of-payments inflows would immediately increase. But we estimate that these initial increases would be turned into a net loss after a period of time. Although it is impossible to determine exactly how long this period of time would be, we estimate that it would be from 5 to 8 years. The reason why this eventual loss would result is that the increased taxes paid by the U.S. subsidiaries would weaken them vis-a-vis their foreign competitors.

The foreign competitors of U.S. companies operating abroad are primarily multinational firms headquartered in Europe, Japan, and Canada. These foreign multinationals on the average are both larger and growing more rapidly than their U.S. counterparts. For instance, in 1971 American companies ranked first in worldwide sales in seven of the nine industries that account for over 90 percent of U.S. foreign direct investment in manufacturing, but by 1973 they ranked largest in only four of the same nine industries. This is but one example of the loss by U.S. companies of their competitive position—as measured by sales. Others will be cited in the report. No one has studied why American firms seem to be losing their competitive position; but it seems very likely that increasing the taxes on their foreign operations would make them lose ground even faster.

In fact, evidence suggests that our Government, rather than placing handicaps on the foreign operations of American companies, should consider whether to encourage them to expand abroad even more. A recent publication of the National Science Foundation states, "The available information, though incomplete, suggests that the United States, on net, benefits from U.S. foreign direct investment." And using information from a variety of sources, we estimate that 700,000 American jobs and a balance-of-payments surplus of $7 billion are created by U.S. operations abroad. These, of course, are quite rough approximations because precise figures are impossible. But it seems very likely that if U.S. companies did not have these foreign operations, the United States would have fewer job opportunities and a weaker dollar than exist today.

Even if the net effects of U.S. foreign direct investment are not known with certainty, there is good reason not to change the present tax system in a way that would weaken those U.S. companies that invest abroad; for they are the strongest part of the U.S. economy. Employment in the United States within these firms has been increasing, whereas employment in other U.S. manufacturing companies has been decreasing.

Furthermore, in the nine U.S. industries that account for over 90 percent of U.S. foreign direct investment in manufacturing, wages and salaries of American employees have been increasing faster than the average of the other U.S. manufacturing industries. As a result, the average income of the employees in the United States in these nine industries exceeds that of the average of the employees in the other U.S. manufacturing industries by about $4,000 a year.

Rather than raise taxes on U.S. companies operating abroad, The Government should begin work on a multilateral tax agreement with other nations where multinational companies are headquartered, in order to insure that American companies pay taxes at the same rates as do their foreign competitors.

I recognize that these conclusions differ substantially from statements of some observers. I am presenting the detailed analysis in this report to aid national policymakers in determining which set of conclusions is most correct.

Thank you for your attention. I would be happy to attempt to answer any questions.

Senator TALMADGE. Thank you, Mr. Stobaugh.

As you know, there is a trend of thought that has much appeal in this country that many of our corporations are fleeing overseas, decreasing business and employment in the United States and increasing them elsewhere in the world. Do you take the position that that statement is not correct?

Mr. STOBAUGH. Yes, sir, I do.

Senator TALMADGE. That foreign investment actually stimulates more jobs in this country.

Mr. STOBAUGH. Foreign investment overseas does stimulate employment in this country. They face powerful competitors overseas.

Senator TALMADGE. You think the additional burdens the House bill would place on corporations doing business overseas would make them less competitive with their counterparts from Germany, France and Canada, and Japan?

Mr. STOBAUGH. Yes, sir, I do. It would make them less competitive in Germany against the German companies and also less competitive against German companies in Brazil.

Senator TALMADGE. You stated this would be more punitive than any system existing in other developed countries in the world?

Mr. STOBAUGH. My judgment is the United States is more punitive in terms of export sales and foreign direct investments than the other major industrial nations of the world.

Senator TALMADGE. Thank you very much for your contribution.

[A critique and a report referred to by Mr. Stobaugh follow: Oral testimony continues on p. 1237.]

U.S. Taxation of U.S. Manufacturing Abroad, Likely Effects of Taxing Unremitted Profits, by Robert B. Stobaugh With the Collaboration of Dario Iacuelli, John C. Kirby, William F. Samuelson, Theodore R. Warren

NOTE: This study is scheduled to be published by the Financial Executives Research Foundation in April 1976.

AUTHOR'S NOTE

Congress has given a lot of attention to the taxation of foreign source income for the past few years. In 1973, I directed a study for the Management Analysis Center (MAC) that provided the basis for my testimony before the Committee on Ways and Means, U.S. House of Representatives, on June 11, 1973.

This current study, which is an updated and revised version of the 1973 report, was funded by a grant from the Financial Executive Research Foundation.

Dario Iacuelli, John C. Kirby, and Theodore R. Warren collaborated with me in preparing the original study. William F. Samuelson constructed the computer simulation model. However, I bear complete responsibility for this report and the conclusions represent my views and not necessarily those of any other person or organization.

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INTRODUCTION AND CONCLUSIONS

For some time there have been proposals in Congress to increase substantially the U.S. taxes on U.S.-owned operations abroad. One of these proposals is to place a U.S. income tax on the unremitted earnings of foreign corporations owned by U.S.-based companies (that is, on those earnings retained by the subsidiary and thus not paid as dividends). Many observes believe that this is likely to receive serious consideration by Congress.

The proposal is often referred to as the "elimination of the deferral of U.S. income tax on foreign earnings." Under the provisions of the current tax law, the profits of foreign corporations owned by U.S. companies are taxed by the host governments at the time they are earned, but such profits are not taxed by the U.S. government until they are remitted to the United States. Hence, U.S. taxes are said to be "deferred" until such time as profits are remitted. At the time of remittance, the profits are taxed at the U.S. rate, except that a credit is given for the income taxes and dividend withholding taxes which have been paid to the foreign government. Thus, in effect, U.S. taxes are collected to the extent that the rate of the total of foreign income and dividend withholding taxes is less than the rate of U.S. income taxes. (There are certain exceptions to this general rule.)

If the United States were to place a tax on unremitted earnings, then U.S.-owned foreign corporations (i.e., subsidiaries) operating in countries with lower tax rates than the United States would be placed at a competitive disadvantage vis-à-vis their foreign competitors, which would continue to pay only local taxes on their retained earnings (that is, earnings not paid as dividends). Of course, those U.S.-owned foreign subsidiaries operating in countries with tax rates equal to or higher than the United States would not be affected.

In this report, we present quantitative estimates of the effect that the legislation might have on selected aspects of the U.S. economy, principally on U.S. taxes collected and on the U.S. balance of payments. We consider only manufacturing operations. We make these estimates by taking into account the foreign tax rates and the probable changes in competitive positions of U.S.-owned foreign subsidiaries over time. These estimates, although based on the most relevant data and concepts that we could find, still incorporate quite a bit of judgment. Good data are hard to come by; but even when good data are available, no economic model exists to give an unequivocal answer.

To be sure, if the U.S. government were to increase the amount of taxes collected from the foreign operations of American[1] companies, U.S. government revenues and the U.S. balance of payments inflows would immediately increase.

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[1] In this report, "America" means the United States.

But we estimate that these initial increases would be turned into a net loss after a period of time. Although it is impossible to determine exactly how long this period of time would be, we estimate, with the aid of a computer simulation model, that it would be from five to eight years. The reason why this eventual loss would result is that the increased taxes paid by the U.S. subsidiaries would weaken them vis-a-vis their foreign competitors.

The foreign competitors of U.S. companies operating abroad are primarily multinational firms headquartered in Europe, Japan, and Canada. These foreign multinationals on the average are both larger and growing more rapidly than their U.S. counterparts. For instance, in 1971 American companies ranked first in worldwide sales in seven of the nine industries that account for over 90 percent of U.S. foreign direct investment in manufacturing, but by 1978 they ranked largest in only four of the same nine industries. This is but one example of the loss by U.S. companies of their competitive position—as measured by sales. Others will be cited later. No one has studied why American firms seem to be losing their competitive position; but it seems very likely that increasing the taxes on their foreign operations would make them lose ground even faster.

In fact, evidence suggests that our government, rather than placing handicaps on the foreign operations of American companies, should consider whether to encourage them to expand abroad even more. A recent publication of the National Science Foundation stated, "The available information, though incomplete, suggests that the United States, on net, benefits from [U.S.] foreign direct investment."[1] And using information from a variety of sources, we estimate that 700,000 American jobs and a balance-of-payments surplus of $7 billion are created by U.S. operations abroad. These, of course, are quite rough approximations because precise figures are impossible. But it seems very likely that if U.S. companies did not have these foreign operations, the United States would have fewer job opportunities and a weaker dollar than exist today.

Even if the net effects of U.S. foreign direct investment are not known with certainty, there is good reason not to change the present tax system in a way that would weaken those U.S. companies that invest abroad; for they are the strongest part of the U.S. economy. Employment in the United States within these firms has been increasing, whereas employment in other U.S. manufacturing companies has been decreasing. Furthermore, in the nine U.S. industries that account for over 90 percent of U.S. foreign direct investment in manufacturing, wages and salaries of American employees have been increasing faster than the average of the other U.S. manufacturing industries. As a result, the average income of the employees in the United States in these nine industries exceeds that of the average of the employees in the other U.S. manufacturing industries by about $4,000 a year.

Rather than raise taxes on U.S. companies operating abroad, the government should begin work on a multilateral tax agreement with other nations where multinational companies are headquartered, in order to ensure that American companies pay taxes at the same rates as do their foreign competitors.

We recognize that these conclusions differ substantially from statements of some observers. We are presenting the detailed analysis in this report to aid national policymakers in determining which set of conclusions is most correct.

CHAPTER I

THE EFFECTS OF U.S. FOREIGN MANUFACTURING INVESTMENT ON THE U.S. ECONOMY

Over the past several years numerous research projects have been conducted in an effort to determine the effects on the U.S. economy of U.S. foreign direct investment in manufacturing. To try to assess the results of such studies, the National Science Foundation recently conducted a colloquium on the subject. Dr. Rolf R. Piekarz of that foundation, in a summary of the findings, wrote, "The available information, though incomplete, suggests that the United States, on net, benefits from [U.S.] foreign direct investment."[2]

The appropriate way to judge the effects of U.S. foreign direct investment on the U.S. economy is to consider what actually happened with such investment

[1] National Science Foundation, Colloquium on "The Effects of International Technology Transfers on the U.S. Economy," October 1973, p. 4.
[2] National Science Foundation, Colloquium of "The Effects of International Technology Transfers on the U.S. Economy," October 1973, p. 4.

compared with what would have happened without such investment. In practice, this is difficult because of the need to estimate what would have happened without such investment. But a number of studies have attempted to answer different aspects of this question, and we rely on such studies for our analysis.

Various economic indicators can be considered in judging the effects of U.S. foreign direct investment on the U.S. economy. Traditionally, observers have been concerned with number of jobs. We use this criterion but also consider the effects on skill levels and incomes of the U.S. workers. Another traditional concern has been the balance-of-payment flows associated with foreign direct investment. Although the use of floating exchange rates has removed much of the prior emphasis on the balance of payments, the issue remains important because a devaluation of a country's currency changes the country's "terms of trade" for the worse—for example, a devaluation of the U.S. dollar means that U.S. workers must work more hours to buy a given amount of foreign goods. Thus we also consider the balance-of-payments effects.

NET EFFECTS OF U.S. FOREIGN DIRECT INVESTMENT

Researchers have used various methods in attempts to determine the net effects of U.S. foreign direct investment.

THE DIFFERENT METHODS

Econometric models

A major economic modeling effort in the 1960's attempted to analyze the consequences to the U.S. balance of payments of U.S. foreign direct investment outflows in manufacturing. The study, which was done by G. C. Hufbauer and F. M. Adler, was important in providing a framework for future analysis. But it is not adequate for policy determination, for its estimates of the results of investment abroad depend mainly upon unexplored and untested assumptions about what would have happened to U.S. exports if U.S. foreign direct investment had not taken place.[2] The results of foreign direct investment generally are favorable to the U.S. balance of payments if one assumes that production from U.S.-owned plants abroad does not displace U.S. exports and unfavorable if one assumes that it does.

Recent economic modeling efforts have served primarily to highlight the difficulties encountered in reaching definite conclusions with that approach. In order to fit the complexities of the real world into the relatively few variables that can be handled in an economic model, researchers are forced into a number of simplifying assumptions. First of all, they have to decide, more or less arbitrarily, which firms to lump together as if they were homogenous. This profoundly affects all that follows. To date, they have had to assume that the dynamic effects of foreign direct investment on the efficiency levels of the home and host countries are inconsequential; that local firms sell products in their home markets that the identical to those made and sold by U.S.-owned subsidiaries abroad; and that exports of intermediate goods from U.S. parents to their subsidiaries can be treated as though they are exports to unaffiliated parties.[3] These are unrealistic assumptions, and a model that uses such assumptions might well produce implausible results. For example, the output of a recent econometric study seemed to show that multinational enterprises do not receive the benefits of economies of scale in their operations and that multinational enterprises attempt to minimize profits—the econometricians who did the study recognized that this conclusion is implausible.[4] Furthermore, the outcome of a model depends on the level of aggregation of the data used by the model builder.[5]

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[2] This study is G. C. Hufbauer and F. M. Adler, "Overseas Manufacturing Investments and the Balance of Payments" (Washington, D.C.: U.S. Treasury Department, 1958). For a discussion of the difficulties in using this study for policy determination, see Raymond Vernon, U.S. Controls on Foreign Direct Investment—A Reevaluation (Financial Executive Research Foundation, 1969), pp. 61–64.

[3] This list is from an article by Michael Adler and Guy V. G. Stevens, "The Trade Effects of Direct Investment," The Journal of Finance, XXXIX (May 1974), pp. 655–676.

[4] *Ibid.*

[5] Another econometrician (Thomas Horst) found what business executives and Government officials have long believed. Tariffs imposed by a foreign country encourage U.S. firms to substitute subsidiary production for U.S. exports. The results are statistically significant at the two-digit level but not at the three-digit level. See Dale Orr's comment on Horst's work in "The Industrial Composition of U.S. Exports and Subsidiary Sales to the Canadian Market: Comment," American Economic Review LXV (March 1975), pp. 230–234; and Horst's "Reply" in the same issue on page 235.

Harvard Business School Case Studies

Given such results from econometricians, policymakers dealing with the effects of U.S. foreign investment likely will be forced to rely on judgment based somewhat on inconclusive evidence. Detailed analyses of individual investment decisions will be necessary in the exercise of that judgment. Because, without such detailed analyses, it is impossible to estimate with any degree of satisfaction what would have happened if U.S. foreign direct investment had not taken place. Detailed studies are needed to estimate such factors as the dynamic effects of an investment and the competitive positions of U.S. firms compared with foreign firms.

Because no prior study has been made of such individual investment decisions, a team at Harvard Business School used this approach in order to estimate the effects of U.S. foreign direct investment on the balance of payments and employment in the United States. (The principal author of this report directed the Harvard study.) A summary of the study was published in 1972 to help policymakers at that time, and a book is scheduled for publication in 1976.[6] (Part of this chapter is drawn from that book).

The Harvard study consisted of a detailed investigation of a foreign investment decision by a U.S. multinational corporation in each of nine major U.S. industries. In selecting the cases, the Harvard team attempted to avoid bias, selecting investments of various sizes, serving various markets, and located in a number of geographical areas. Furthermore, these investments were made in both wholly owned subsidiaries and joint ventures, and both new subsidiaries and expansions of existing subsidiaries. Although no single investment can possibly represent the behavior of the industry from which it is drawn, the Harvard team attempted to get relevant variety by sampling from the nine industries that collectively account for over 90 percent of the sales of U.S.-controlled manufacturing facilities abroad.[7]

The Harvard study was distinguished from all other studies by the attempt to estimate what would have happened to the U.S. balance of payments and U.S. employment if the foreign direct investment had not been made and if no other U.S.-owned firm could have expanded production abroad to serve the market served by the facility actually built. Thus, in the "what might have been" scenarios, if the market in question were to be served, and if the investment in question were not made, the goods would have to come from one of the following sources:

(1) facilities in the United States, either existing or built especially for this purpose;

(2) facilities located in the host country, either existing or built especially for this purpose, and owned by firms not controlled from the United States; or

(3) facilities located in a third country, either existing or built especially for this purpose, and owned by firms not controlled from the United States.

In each case, the Harvard team explicitly studied the profit that the firm would earn by producing in the United States rather than abroad and then drew conclusions about the firm's likely actions. It is obvious that the results rely heavily on estimates concerning the foreign competition faced by U.S. firms. Hence, in each industry a thorough study was made of competition and patterns of investment and trade. In every case the Harvard team—not the companies—was responsible for the estimates that were used.

The net effects of the U.S. firm's expansion abroad were obtained by subtracting the estimates of the "what might have been" case from the estimates of the U.S. balance of payments and employment that occurred or were expected to occur with the expansion. The Harvard team, by feeding its results into a

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[6] The results will appear in a forthcoming book (part of this testimony is drawn from this book), Robert B. Stobaugh, et al., "Nine Investments Abroad and Their Impact at Home" (Boston: Harvard Business School, Division of Research, forthcoming 1975). A summary of the study was published in Robert B. Stobaugh, et al., "U.S. Multinational Enterprises and the U.S. Economy," in Bureau of International Commerce, U.S. Department of Commerce, The Multinational Corporation, Volume I (Washington: Superintendent of Documents, 1972); and for a briefer version, see Robert B. Stobaugh, "How Investment Abroad Creates Jobs at Home," Harvard Business Review, September–October 1972. A fuller discussion of this methodology is in Piero Telesio, "Part I," of Robert B. Stobaugh, Piero Telesio, and Jose de la Torre, "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment, and Changes in Skill Composition of Employment," Occasional Paper No. 4 of Center for Multinational Studies, Washington, D.C., February 1973.

[7] See "source" of Tables 1–4 for list of industries.

framework provided by the Hufbauer-Adler model, concluded that U.S. foreign direct investment in manufacturing is beneficial to the U.S. economy.

The reason that the results are positive is that most U.S. foreign direct investment in manufacturing is undertaken because the firm has no other long-range viable alternative to serve the market that the foreign facility serves. For if U.S.-owned plants had not been built, foreign firms, many of which are European or Japanese multinational enterprises, would have built the facilities to serve the market. Thus, a U.S. plant built abroad to serve a market in place of U.S. exports usually is not responsible for the resulting loss in such exports, for these exports would be lost ultimately anyway. Rather, U.S.-owned plants abroad increase U.S. exports because U.S. foreign affiliates have a greater propensity to obtain equipment, components, and finished products from the United States than do foreign firms. The foreign firms are less familiar with U.S. sources of supply and more familiar with foreign sources than are U.S. firms, and, of course, foreign affiliates of European and Japanese enterprises are more likely to import components from their parents than from the United States.

Although the Harvard study was intended to help policymakers in reaching a judgment, the cases should be viewed as one piece of evidence to be combined with other available pieces. The situation is similar to a search for oil. Even though a lot can be learned about surveys over a broad area, a few deep wells provide vital information—and the Harvard cases were intended to serve as "deep wells."

The value of the nine cases comes not so much from nine situations *per se* as from the fact that the central conclusion—U.S. firms with foreign manufacturing facilities would eventually lose the market served by their foreign plants if the firms had not built the foreign plants—is consistent with subsequent research results at Harvard and with other analyses using a different methodology.

Other studies

Additional research now under way at Harvard, in which the international manufacturing strategies of 30 U.S. multinational enterprises are being studied, is further confirming the hypothesis that most U.S.-owned plants are built abroad primarily because the U.S. firm has no other promising long-range alternative to serve the market intended to be served by the foreign plant.[8] And this conclusion seems to apply not only to those foreign plants that serve the local markets but also to those that serve export markets including the so-called "offshore" plants, which ship their products to the United States. A recently completed study concluded that competition from U.S. imports of foreign products was an important factor in causing U.S. electronic firms to produce abroad in offshore plants for the U.S. market.[9]

Industry data published with the summary of the nine causes in 1972 are generally consistent with the central conclusion. They depict the gradual loss over time of economic position by the United States within any one industry or subindustry. This loss occurred in 90 out of 119 cases in which U.S. competitiveness in an industry or subindustry was measured over time.[10] Four measures of competitiveness were used: (1) production in the United States as a percentage of world production, (2) production worldwide by U.S. firms as a percentage of world production, (3) U.S. exports as a percentage of world exports, and (4) U.S. net trade balance.

Raymond Vernon mentions a number of studies in his "Sovereignty at Bay.[11] And a study of a sample of nine representative chemicals (by the principal author of this report) found that no firm, either U.S. or non-U.S., made a foreign direct investment until a foreign company had commenced manufacture of the product. In other words, the original producer always built the first plant in its own home country and always supplied the world market from this plant until a foreign

[8] The results of five additional case studies are included with four of the earlier mentioned nine case studies in Robert B. Stobaugh, et al., "The Effects of U.S. Manufacturing Investments in Less-Developed Countries on the U.S. Balance of Payments and U.S. Employment Levels" (mimeograph), Harvard Business School, 1974.

[9] Richard W. Moxen, "Off Shore Production in the Less-Developed Countries by American Companies," New York University Graduate School of Business Administration Special Series, 1974.

[10] Robert B. Stobaugh, et al., "U.S. Multinational Enterprises and the U.S. Economy," in Bureau of International Commerce, U.S. Department of Commerce, The Multinational Corporation, Volume I (Washington: Superintendent of Documents, 1972), Exhibit 4.

[11] Raymond Vernon, "Sovereignty at Bay" (New York: Basic Books, 1971), Chapter 3.

competitor started production outside the original producer's home country. This study covered the entire universe of manufacturing facilities for those products—350 worldwide—and the entire history of the products—some 60 years.[12]

Some analysts have maintained that if U.S. foreign direct investment had not taken place, then the funds would have been invested in the United States.[13] The U.S. Tariff Commission, in its study of multinational enterprises, disagrees with such a conclusion because U.S. monetary policy is much more dominant in affecting U.S. investment than is the amount of funds involved in U.S. foreign direct investment; the Tariff Commission states explicitly: "One can safely assume a zero net effect on domestic investment when the foreign investment takes place." [14] The Tariff Commission study is consistent with those econometric studies which conclude that demand for goods rather than supply of funds is a major determinant of investment within the United States.[15] And a recent study by two scholars, Richard Herring and Thomas O. Willett, concluded that U.S. investment by U.S. firms and foreign investment by U.S. firms seemed to be complements for one another rather than substitutes—during years in which plant and equipment expenditures by U.S. firms abroad were relatively high, U.S. domestic plant and equipment expenditures also were relatively high.[16]

Still, even if one assumes that a dollar invested abroad by a U.S. firm subtracts a dollar from investment in the United States, the effect of U.S. foreign direct investment on the U.S. balance of payments is changed very little.[17]

RESULTING ESTIMATES

In preparing the 1972 summary of the results of their case studies, the Harvard team relied on variegated evidence of the sort discussed above to arrive at estimates of the net effects of U.S. foreign direct investment on U.S. employment and the U.S. balance of payments. They estimated that U.S.-owned manufacturing operations abroad were responsible in 1970 for some 600,000 U.S. jobs and made a net positive contribution to the U.S. balance of payments of some $3.5 billion. Because of the rapid growth of U.S. manufacturing operations abroad, comparable figures for 1975 are some 700,000 U.S. jobs and a net positive contribution to the U.S. balance of payments of some $7 billion.[18] But the original estimates were published with the caveat that they were based more on judgment than on relationships that were the results of empirical tests and that no one should claim that any such estimates are accurate.[19] The caveat still holds today.

These benefits of U.S. foreign direct investment give only part of the picture of the contribution of U.S. multinational enterprises to the U.S. economy.

It is now recognized that foreign direct investment enables an enterprise to make more profitable use of its techology, marketing knowledge, and other tangible and intangible assets as a package than if the enterprise sold one or more of the elements separately. And, of course, the United States is the recipient of such profits attributable to foreign direct investment by U.S. enterprises.[20] But even if the United States does profit from investments abroad by U.S. firms, the redistribution effects caused within the United States are uncertain. But one thing is sure: the optimal way to attain any income distribution goal is never one that reduces total income available for redistribution.[21] Indeed, the

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[12] Robert B. Stobaugh, "The Product Life Cycle, U.S. Exports, and International Investment," unpublished D.B.A. thesis, Harvard Business School, 1968.

[13] See Peggy Musgrave's Feb. 28, 1973, testimony before the Ways and Means Committee, for example.

[14] U.S. Tariff Commission, "The Multinational Corporation and the World Economy" (Washington, U.S. Government Printing Office, 1973), p. 649.

[15] See Dale W. Jorgenson and Calvin D. Siebert, "A Comparison of Alternate Theories of Corporate Investment Behavior," The American Economic Review (September 1968), pp. 681–712.

[16] Richard Herring and Thomas D. Willett, "The Relationship Between U.S. Direct Investment at Home and Abroad," Rivista Internationale di Scienze Economiche e Commerciali (1973, n.1), p. 78. This is the conclusion drawn by the U.S. Tariff Commission, op. cit., p. 328.

[17] Hufbauer and Adler, op. cit., p. 57.

[18] Prorated from data in Survey of Current Business, August 1974, Part II, pp. 17 and 28; and Piero Telesio, op. cit., pp. 11, 12 and 18.

[19] Robert B. Stobaugh, et al., "U.S. Multinational Enterprises and the U.S. Economy," pp. 30–31.

[20] Richard E. Caves, "Effect of International Technology Transfers on the U.S. Economy," in Rolf R. Piekarz (ed.), "The Effects of International Technology Transfers on U.S. Economy" (Washington, D.C.: Superintendent of Documents, 1974), pp. 34–35.

[21] Caves, op. cit.

optimal approach would be to maximize the nation's income and then redistribute it to the desired pattern. The federal government has shown some capability to redistribute income, with redistribution running into tens of billions of dollars yearly.

A simple economic model consisting of labor and capital in a static setting will suggest that the export of capital by U.S. multinational enterprises leaves U.S. labor with less capital with which to work than if such exports of capital did not take place. So presumably, foreign direct investment results in lower returns to labor and higher returns to capital. For policymaking purposes, however, one has to go a step further and take into account the dynamic effects of U.S. foreign direct investment on the composition of the U.S. workforce.

Perhaps the most important finding of the Harvard Business School study of nine cases is that employment created in the United States as a result of U.S. foreign direct investment is of a higher skill level than exists on the average in U.S. manufacturing industries (Tables 1-1 and 1-2). The average of U.S. manufacturing was used as a base for comparison on the assumption that the U.S. jobs involved in the adjustment process associated with foreign direct investment came from the maufacturing sector. In fact, if the alternative to U.S. foreign direct investment were the protection of U.S. industries through the imposition of import duties or quotas, then the increase in skill level caused by U.S. foreign direct investment would be even greater, because labor skills in import-competing industries in the United States are lower than the average for U.S. manufacturing.[22] Furthermore, the case studies omitted an important aspect of U.S. foreign direct investment—the creation of U.S. jobs in research and development establishments in the United States.[23]

TABLE 1-1.—SKILL COMPOSITIONS OF SELECTED WORK FORCES, CIRCA 1970

[Percent of labor force]

Skill Category [1]	Average for U.S. manufacturing (1)	Average of jobs created by 9 U.S. foreign direct investments studied by Harvard: Total for both investing firm and supplier firms (2)	Average of jobs created by 9 U.S. foreign direct investments studied by Harvard: Investing firm only (3)	U.S. average of investing firm's industry (4)
I. Professionals	15	31	57	18
II. Skilled	19	20	12	19
III. Clerical and sales	16	11	6	16
IV. Semiskilled and unskilled	50	38	25	47
Total	100	100	100	100

[1] Definitions are from source; table 1-2 shows a detailed description of each category. Order of skill levels is from Donald B. Keesing, "Labor Skills and International Trade: Evaluating Many Trade Flows With a Single Measuring Device," Review of Economics and Statistics (August 1965), pp. 287-294.

Sources: Col. (1) from Bureau of Labor Statistics, U.S. Department of Labor, "Tomorrow's Manpower Needs," vol. IV, revised 1971, Bulletin 1737 (Washington, D.C.: Government Printing Office, 1972), pp. 33-35.
Cols. (2), (3), and (4) from Robert B. Stobaugh, Piero Telesio, and Jose de la Torre, "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment and Chages in Skill Composition on Employment," occasional paper No. 4 for Center for Multinational Studies, Washington, D.C., February 1973, p. 40.

TABLE 1-2.—DEFINITIONS OF SKILL LEVELS, UNITED STATES

SKILL LEVEL AND DEFINITION

I. Professionals: Professional, technical engineers; natural scientists; technicians, excluding medical, dental; medical, other health workers; teachers; social scientists; other professional, technical and kindred; managers, officials, proprietors.

[22] Donald B. Keesing, Peter B. Kenen, Helen Waehrer, and Merle I. Yahr, contributors to Peter B. Kenen and Roger Lawrence, "The Open Economy: Essays on International Trade and Finance" (New York: Columbia University Press, 1968.)

[23] A rough estimate of home office and research and development jobs created in the United States as a result of U.S. foreign direct investments is given in Raymond Vernon, "A Skeptic Looks at the Balance of Payments," Foreign Policy (Winter 1971-1972), pp. 52-65.

II. Skilled: Craftsmen, foremen and kindred; construction craftsmen; foremen; metalworking craftsmen, excluding mechanical; printing trades craftsmen; transport and public utilities craftsmen; mechanics and repairmen; other craftsmen and kindred.

III. Clerical and sales: Clerical and kindred workers; stenos, typists, secretaries; office machine operators; other clerical, kindred workers; sales workers.

IV. Semiskilled and unskilled: Operatives and kindred workers; drivers and deliverymen; transportation and public utilities operatives; semiskilled metalworking occupations; semiskilled textile occupations; other operatives and kindred; service works; private household workers; protective service workers; food service workers; other service workers; laborers, except farm and mine.

V. Farmers and farm workers (not relevant to this study).

NOTE: Definitions are from source. Order of skill levels is from Donald B. Keesing, "Labor Skills and International Trade: Evaluating Many Trade Flows With a Single Measuring Device," Review of Economics and Statistics (August 1965), pp. 287-94.

SOURCE: Bureau of Labor Statistics, U.S. Department of Labor, Tomorrow's Manpower Needs, Vol. IV, Revised 1971, Bulletin 1737 (Washington, D.C.: Government Printing Office, 1972).

But if U.S. foreign direct investment does increase job skills and incomes in the United States, another question arises: How much does it cost to achieve this increase in income? I know of no available data which enable that question to be answered, but there is evidence to support the view that an employment cycle exists in the life of each of the industrial sectors (such as industries or subindustries) that together make up the U.S. manufacturing economy. In each industrial sector total employment rises during the early part of the sector's life cycle and then falls during the latter part. This fall is caused by a combination of a slow-up of growth or even an absolute fall in demand for the products produced by the sector,[34] an increase in production efficiency,[35] and an increase in imports.[36] U.S. foreign direct investment helps an industrial sector to gain employment during its middle stages and to lose employment in its declining stages.[37]

If normal attrition in the "old" sectors reduces the supply of labor in proportion to the fall in requirements for labor, then the relevant cost of adding persons at the middle stages of the industry's life cycle because of U.S. foreign direct investment is the cost of training. But if attrition is not sufficient to reduce labor supply to meet the requirements and workers must be moved from an "old" sector, then the relevant cost is that of retraining and relocating the displaced workers.

A simplistic view of the process is that the U.S. foreign direct investment enables the sons and daughters of unskilled workers to become skilled workers producing relatively new components and equipment for U.S.-owned facilities abroad or to obtain M.B.A. or Ph.D. degrees and become managers or scientists in multinational enterprises rather than to follow their parents into unskilled jobs. To be sure, the creation of highly skilled jobs for the sons and daughters is favorable. Higher skill levels are associated with higher income and job satisfaction for the individual,[38] and a higher standard of living for society as a whole. But to complete the picture, one must consider the parents. And the overall results are favorable to the extent that the parents can keep their jobs until normal retirement; but they are less favorable to the extent that the parents lose their jobs—sometimes with a loss of pension rights—and are forced to move to another community or to receive welfare payments. Much more study of this phenomenon is needed.

But even if there is considerable uncertainty surrounding the exact economic effects of U.S. foreign direct investment, there is a case to be made for not changing the present system; because U.S. foreign direct investors, especially the largest of these—the so-called multinational enterprises—are very important to the U.S. economy. And, in fact, they are more healthy economically in the United States than other U.S. manufacturing companies.

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[34] Victor Cook and Rolando Polli, "Validity of the Product Life Cycle," Journal of Business (October 1969), pp. 385–400.

[35] Due both to static and dynamic scale economies; see Robert B. Stobaugh and Phillip L. Townsend, "Price Forecasting and Strategic Planning: The Case of Petrochemicals," Journal of Marketing Research, XII (February 1975), pp. 19–29.

[36] Louis T. Wells, Jr. (ed.), "The Product Life Cycle and International Trade" (Boston: Division of Research, Harvard Business School, 1972).

[37] This hypothesis is consistent with the idea that U.S. foreign direct investment extends the firm's participation in a market longer than otherwise would be the case; see Raymond Vernon, "Sovereignty at Bay," Chapter 3.

[38] "Dissatisfaction with Job Grows," The Boston Globe, June 1973.

U.S. FOREIGN DIRECT INVESTORS COMPARED WITH OTHER U.S. COMPANIES

The domestic sales of the 187 U.S. companies classified as multinational enterprises by the Harvard Business School Multinational Enterprise Project account for one-third of the total domestic sales of U.S. manufacturing firms.[29] These 187 companies do two-thirds of the privately funded industrial research and development performed in the United States.[30] And a detailed look at figures on employment and balance of payments further shows the importance of U.S. foreign direct investors.

EMPLOYMENT

The U.S. employment of U.S. foreign direct investors in manufacturing has been increasing faster than U.S. employment in other manufacturing firms.

For example, U.S. government statistics show that U.S. employment in multinational enterprises in the manufacturing industries increased by 7.6 percent from 1966 to 1970, whereas the average employment in all other U.S. manufacturing firms decreased by 2.4 percent, during the same period (Table 1-3). And, within some individual industries, the average growth in employment of the multinational enterprises exceeded that of the other firms by very wide margins. (An unanswered question is the extent to which mergers contributed either to these results or to other results mentioned below.)

The results are consistent with the findings of studies that the business community has produced. For example, Business International, in a study of 135 multinational enterprises, and the Emergency Committee on American Trade, in a survey of 74 U.S. multinational enterprises, found that employment in U.S. multinational firms had increased faster than employment in U.S. manufacturing as a whole.[31]

TABLE 1-3.—U.S. EMPLOYMENT OF 2233 U.S.-BASED MULTINATIONAL ENTERPRISES IN MANUFACTURING COMPARED WITH OTHER FIRMS IN SAME INDUSTRIES, 1966 AND 1970

[In thousands unless otherwise noted]

Industry category	U.S. multinational enterprises			All other U.S. firms in same industry category		
	1966	1970	Growth 1966–70 (percent)	1966	1970	Growth 1966–70 (percent)
Food products	235	260	10.6	1,554	1,524	−1.3
Chemicals and allied products	665	725	9.0	301	329	9.3
Primary and fabricated metals	709	724	2.1	1,993	1,974	−1.0
Machinery	1,617	1,860	15.0	2,214	2,046	−7.6
Transportation equipment	1,681	1,568	−6.7	529	495	−6.4
Other manufacturing	978	1,198	22.5	6,629	6,521	−1.6
Total manufacturing	5,885	6,335	7.6	13,210	12,889	−2.4

Source: "Survey of Current Business," October 1973, p. 37. There were 298 firms in the Department of Commerce group of U.S.-based multinational enterprises, but only 223 were classified as manufacturing firms. See U.S. Department of Commerce, Bureau of Economic Analysis, "Special Survey of U.S. Multinational Companies," 1970, p. 3.

And data aggregated by industry are consistent with these findings. For example, the nine U.S. industries that lead in terms of foreign direct investment account for over 90 percent of the sales of foreign affiliates of U.S. foreign direct investors in manufacturing.[32] Employment in these nine industries has been growing at a faster rate than the average for the other manufacturing industries, 4.3 percent compared with 2.6 percent from 1970 to 1973 (Table 1–4).

In a somewhat similiar approach, Robert G. Hawkins of New York University split U.S. manufacturing industries into two groups: those whose foreign-affiliate

[29] See Raymond Vernon, "Sovereignty at Bay," op. cit.
[30] Vernon, op. cit., and National Science Foundation, "Research and Development in Industry" (Washington, D.C.), various issues, such as 1970.
[31] Business International, "The Effects of U.S. Corporate Foreign Investment, 1960–1970," New York, 1972; and Emergency Committee on American Trade, "The Role of Multinational Corporations in the U.S. and World Economies," Washington, D.C., 1972.
[32] Listed in table 1–4.

sales were more than 10 percent of domestic sales, and those whose foreign-affiliate sales were less than 10 percent. He found that domestic employment has been expanding more rapidly in the "high" investors than in the "low" investors.[28]

The average annual compensation per employee in the United States in the nine U.S. industries accounting for the bulk of U.S. foreign direct investment in manufacturing grew more from 1970 to 1973 than the average of the other manufacturing industries. Also, compensation per employee is higher than the average of the other manufacturing industries, being $12,800 compared with $9,600 in 1973 (Table 1-5). By projecting this past trend to the present, we conclude that the average annual compensation of U.S. employees in these nine industries is about $4,000 more than the average of employees in the other U.S. manufacturing industries.

TABLE 1-4.—NUMBER OF FULL-TIME EQUIVALENT EMPLOYEES BY U.S. INDUSTRY, 1970 AND 1973

[In millions unless otherwise noted]

Industry category	1970	1973	Growth, 1970-73 (percent)
9 industries which account for over 90 percent of the sales of the foreign affiliates of U.S. foreign direct investors in manufacturing	11.7	12.2	4.3
Other manufacturing industries	7.7	7.9	2.6

Source: Data from "Survey of Current Business," July 1974, p. 37. List of 8 industries from ibid., August 1974, pt. II, p. 27; petroleum refining which is listed as part of the "petroleum" industry rather than "manufacturing" in the source, was added by authors of this report to be the 9th industry. Thus, the 9 industries are: food products, paper and allied products, chemicals and allied products (including pharmaceuticals), petroleum refining, rubber products, primary and fabricated metals, nonelectrical machinery, electrical machinery, and transportation equipment (primarily automotive). This list is consistent with the Harvard Business School study of 9 cases discussed later in this chapter. But it differs from the list of industries mentioned in ch. 2—in that chapter the pharmaceutical industry was classified as a separate industry because of its importance and because it is clearly distinct from the chemical industry; and petroleum refining was dropped because refining sales are merged with other sales of oil companies in the "Fortune" lists and thus are not readily available. Furthermore, petroleum refining might be affected differently from manufacturing by a change in U.S. tax laws. These slight differences in industry lists have no meaningful effect on any conclusions drawn in this study.

TABLE 1-5.—AVERAGE COMPENSATION PER FULL-TIME-EQUIVALENT EMPLOYEE BY U.S. INDUSTRY, 1970 AND 1973

[In thousands of dollars unless otherwise noted]

Industry category	1970	1973	Growth, 1970-73	
			Absolute	Percent
9 industries which account for over 90 percent of the sales of foreign affiliates of U.S. foreign direct investors in manufacturing	+$10.3	$12.8	$2.5	24
Other manufacturing industries	8.1	9.6	1.5	19

Source: Calculated from "Survey of Current Business," July 1974, pp. 36, 37.

BALANCE OF PAYMENTS

Figures on the U.S. balance of payments show that inflows from U.S. foreign direct investment have been getting relatively larger. Direct investment receipts from foreign affiliates of U.S. manufacturing firms grew from $2.9 billion in 1970 to $4.3 billion in 1973 (Table 1-6). The net inflows, after deducting outflows of capital, increased from $1.6 billion in 1970 to $2.5 billion in 1973. These numbers do not include data, which are not available, on the foreign manufacturing activities of firms in non-manufacturing industries such as petroleum and mining; thus, they understate the total receipts due to U.S.-owned manufacturing activities abroad. However, the total receipts of U.S. foreign direct investment by all U.S. industries are almost triple those of the U.S. manufacturing industries alone (Table 1-7 compared with Table 1-6).

[28] Robert C. Hawkins, "U.S. Multinational Investment in Manufacturing and Domestic Economic Performance," Occasional Paper No. 1, Center for Multinational Studies, Washington, D.C., February 1972.

TABLE 1-6.—U.S. BALANCE-OF-PAYMENTS INFLOWS AND OUTFLOWS, U.S. FOREIGN DIRECT INVESTMENTS OF MANUFACTURING INDUSTRIES, 1970 TO 1973

[In billions of dollars]

	1970	1971	1972 [1]	1973 [1]
Inflows:				
Royalties and fees from affiliated foreigners	$1.0	$1.1	$1.3	$1.6
Interest, dividends and branch earnings	1.9	2.0	2.1	2.8
Total (recorded as an export of services)	2.9	3.1	3.4	[2] 4.3
Outflows	1.3	1.6	1.1	1.8
Net balance-of-payments inflows	1.6	1.5	2.3	2.5

[1] Preliminary.
[2] Because of rounding, this column does not add exactly to the total.
Source: "Survey of Current Business," August 1974, pt. III, pp. 17 and 22.

TABLE 1-7.—U.S. BALANCE-OF-PAYMENTS INFLOWS AND OUTFLOWS, U.S. FOREIGN DIRECT INVESTMENTS OF ALL U.S. INDUSTRIES, 1970-73

[In billions of dollars]

	1970	1971	1972 [1]	1973
Inflows:				
Royalties and fees from affiliated foreigners	$1.9	$2.2	$2.4	$2.8
Interest, dividends and branch earnings	5.3	6.4	6.9	9.4
Total (recorded as an export of services)	7.2	8.6	9.3	12.2
Outflows	4.4	4.9	3.5	4.9
Net balance of payments inflows	2.8	3.7	5.8	7.3

[1] Preliminary.
Source "Survey of Current Business," August 1974, pt. II, pp. 16 and 22.

These inflows are relatively important when compared with the overall U.S. trade balance. In 1973, for example, the U.S. balance of trade in goods and services was a negative $7.8 billion without considering U.S. foreign direct investment inflows. But when the $12.2 billion of inflows are considered, the total trade balance becomes a positive $4.4 billion (Table 1-8). The U.S. trade balance without the inflows from U.S. foreign direct investment was very negative each year from 1970 through 1973; but with the foreign direct investment inflows the trade was positive in three of the four years. These inflows help provide funds for both investment and consumption in the United States.

These balance-of-payments inflows of U.S. foreign direct investors do not include the foreign trade of such investors, which also makes a positive contribution to the overall U.S. balance of payments. The large U.S. foreign direct inves-

TABLE 1-8.—RELATIONSHIP BETWEEN U.S. FOREIGN DIRECT INVESTMENT INFLOWS AND OTHER U.S. TRADE 1970-73

[In billions of dollars]

Line		1970	1971	1972	1973
1	Exports of goods and services	$62.9	$66.2	$73.5	$101.0
2	Of which accounted for by foreign direct investment inflows	7.2	8.6	[1] 9.3	[1] 12.2
3	Exports of goods and services excluding U.S. foreign direct investment inflows.	55.7	57.6	64.2	88.8
4	Imports of goods and services	59.3	65.4	77.8	96.6
5	Trade balance excluding U.S. foreign direct investment inflows.	−3.6	−7.8	−13.6	−7.8
6	Trade balance including U.S. foreign direct investment inflows (line 2 plus line 5).	3.6	.8	−4.3	4.4

[1] Preliminary.

Source: Exports of goods and services obtained from "Survey of Current Business"; March 1975, p. 34 (for 1973); and March 1974, p. 44 (for 1972); March 1973, p. 32 (for 1971); and March 1972, p. 44 (for 1970).

tors, the so-called multinational enterprises that account for most U.S. foreign direct investment, had a $5.8 billion trade surplus in 1966 and $7.8 billion surplus in 1970 (as measured by trade associated with these firms, see Table 1–9). Other U.S. trade was in deficit by $1.4 billion in 1966 and this deficit grew to $5.5 billion in 1970 (these are the only two years for which such data are available).

Thus, U.S. foreign direct investors seem to be a bright spot in the U.S. economy. Of course, additional study is needed to determine more precisely the economic effects of U.S. foreign direct investment. But, in the meantime, the architects of social policy cannot always wait for more information and more understanding. And issues such as the readjustment needs of displaced workers should be dealt with now. But the remedies should be fashioned in ways that recognize not only the special problems of the multinational firm but also the special values that such firms generate for the U.S. economy.

TABLE 1–9.—FOREIGN TRADE OF UNITED STATES ASSOCIATED WITH 293 U.S. MULTINATIONAL ENTERPRISES COMPARED WITH OTHER U.S. TRADE, 1966 AND 1970

[In billions of dollars]

	1966	1970
Multinational enterprises:[1]		
Exports	$13.7	$21.2
Imports	8.4	13.6
Surplus	5.3	7.6
Other trade:		
Exports	15.6	20.7
Imports	17.0	26.2
Surplus	−1.4	−5.5

[1] Defined by the U.S. Department of Commerce on the basis of the size of their foreign investments.

Source: "Survey of Current Business," December 1972, p. 21.

Chapter 2

COMPETITION ENCOUNTERED BY U.S. COMPANIES THAT MANUFACTURE ABROAD

For some time it has been commonly believe that U.S.-based multinational enterprises are so large that they dominate their foreign competitors.[1] This belief is given support by a superficial examination of conditions that existed just a few years ago. For example, consider a tabulation of the worldwide sales in 1971, *including* those in the United States, of the largest ten firms (whether U.S.-based or not) in the nine industries in which U.S. foreign direct investment in manufacturing is concentrated.[1a] As shown in Table 2–1, U.S. firms were the world's largest in seven of these nine industries; furthermore, 48 of these top 90 firms, or 48 percent were U.S.-owned and these U.S. firms were concentrated in the first five ranks.[2] But as shown later in this chapter, the positions of the U.S. firms have deteriorated since 1971.

[1] The literature on this point is too extensive to be quoted here, but J. J. Servan Schreiber is perhaps the most articulate propagator of this view. See his "The American Challenge" (New York: Atheneum, 1968).

[1a] These nine are food products, paper and allied products, chemicals and allied products (excluding pharmaceuticals), pharmaceuticals, rubber products, primary and fabricated metals, non-electrical machinery, electrical mahinery, and automotive. See Table 1–4.

[2] It has long been reognized that size is an important measure of competitive strength—it provides scale economies in management, research and development, marketing, production, finance and risk-taking. Annual sales volume probably is the most widely used proxy for size; but others, such as book value, also are used. We use both annual sales volume and book value, depending upon which one was used in the original source of data. Scale economies of multinational enterprises are a central theme of Raymond Vernon, "Sovereignty at Bay" (New York: Basic Books, 1971). Also, scale of economies in management, production, finance and risk-taking are discussed in Stephen Hymer and Robert Rowthorn, "Multinational Corporations and International Oligopoly: The Non-American Challenge," in Charles Kindelberger (ed.), "The International Corporation" (Cambridge, Mass.: Ballinger, 1974). Scale economies in marketing administration are discussed in Ullich Weichman, "Marketing Management in Marketing-Intensive Multinational Firms," unpublished D.B.A. thesis, Harvard Business School, 1974. Scale economies in reesearch and development are discussed in Raymond Vernon, "Organization as a Scale Factor in the Growth of Firms," in Jesse W. Markham and Gustav F. Papanek (eds.), "Industrial Organization and Economic Development" (Boston: Houghton Mifflin, 1970), pp. 47–66; and in Robert C. Ronstadt, "R&D Abroad: The Creation and Evolution of Foreign Research and Development Activities of U.S.-Based Multinational Enterprises," unpublished D.B.A. thesis, Harvard Business School, 1975.

TABLE 2-1.—RANK OF U.S. FIRMS AMONG 10 FIRMS WITH LARGEST SALES IN 9 INDUSTRIES, WORLDWIDE INCLUDING UNITED STATES, 1971

Rank	Food products (20)[1]	Paper and allied products (26)[1]	Chemicals and allied products (28, excluding 283)[1]	Pharmaceuticals (283)[1]	Rubber products (30)[1]	Primary and fabricated metals (33 and 34)[1]	Nonelectrical machinery (35)[1]	Electrical machinery (36)[1]	Automotive (371)[1]	Total number of U.S. firms
1		United States	United States		United States	United States	United States	United States	United States	7
2		United States		United States	United States		United States	United States	United States	6
3	United States	United States					United States	United States	United States	5
4	United States	United States		United States	United States	United States	United States			6
5		United States	United States	United States						3
6	United States	United States		United States	United States			United States		5
7	United States			United States	United States		United States			4
8	United States						United States			2
9	United States		United States				United States			3
10			United States	United States						2
Number of U.S. firms in top 10.	6	6	4	6	6	2	7	4	3	43

[1]Standard industrial classification of U.S. industries.

Note: No entry in table equals foreign firm.

Source: Fortune, the "Fortune Directory of the 500 Largest U.S. Industrial Corporations, May 1972;" the "Fortune Directory of the 300 Largest Industrials Outside the United States, August 1972." For list of firms, see table A-1 in appendix.

To be sure, a firm's sales in the United States can affect its competitive position outside the United States—knowledge and money generated in the United States can be sold abroad. But for our purpose—that is, to estimate the effect of placing a U.S. tax on the unremitted foreign earnings of U.S. companies that manufacture abroad—worldwide sales including those in the United States are certainly not the only measure. Success in a foreign country often depends heavily on the size of an operation in that country. Thus, it is relevent to compare the operations of U.S. firms outside the United States with the operations of their foreign competitors. We do this by comparing worldwide sales excluding those in the United States of U.S. firms and their principal foreign competitors. We also make two additional comparisons that seem relevant and for which we could find data.

We compare the sales of U.S. multinational enterprises outside the United States with the sales of non-U.S. multinational enterprises outside their respective home countries. We do this because the foreign competitors of U.S. multinational enterprises primarily are mutlinational firms themselves, mostly with headquarters in Europe, Japan, and Canada;[3] and the operation of a worldwide network of manufacturing facilities brings a somewhat different set of management problems than operating just in one country.[4]

However, competition takes place in individual product lines within certain market boundaries. Thus, we also use such data for a comparison of U.S. firms and their foreign competitors.

Most of the above comparisons are available only for 1970 or 1971. So we first present a comparison of conditions in 1970–1971. Then, with the meager data readily available on a consistent basis between 1971 and 1973, we show what happened in this time period in order to assess trends in competitive strength.

Because we obtained whatever data were available to illuminate this little-known phenomenon, it is inevitable that we draw from a variety of sources, and it is not surprising that these sources used different measures of size, included different samples of firms, and included different geographical areas. But, as shown below, the data seem consistent with a central theme—the foreign competitors of U.S. firms that manufacture abroad on the average are now both larger and growing faster than their U.S. counterparts.

A Static View: Conditions in 1970 and 1971

Worldwide Sales Excluding Those in the United States

If sales within the United States are excluded in a comparison, the results are quite a bit different from the competitive position depicted in Table 2–1. The U.S. firms drop substantially vis-a-vis their foreign competitors, the reason is simple: U.S. firms have a large share of their sales in the United States than do foreign firms. In the same nine industries shown in Table 2–1, we were able to identify 87 firms that have an important amount of sales outside the United States—ten in each industry except rubber products, in which we could identify only seven. To be sure, the U.S. firms were well-represented in this group, constituting 46 percent of the total (40 of 87). But they were concentrated in the lower five ranks (Table 2–2). A comparison of Table 2–2 with Table 2–1 shows at a glance the great importance of U.S. sales to U.S.-based firms in a comparison with their foreign competitors. In seven of the nine industries, the sales outside the United States by the leading foreign firms were larger than those of the leading U.S. firms.

Further, in a number of the industries there were several foreign firms with sales larger than those of the U.S. firm with the largest sales; and there were eight in one case (primary and fabricated metals), see Table 2–3. Also, in some industries the sales of the largest foreign firm were substantially larger than those of the U.S. firm with the largest sales—they were 15 times as much in one case (food products).

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[3] For evidence, see Edward M. Graham, "Oligopolistic Imitation and European Direct Investment in the United States," unpublished D.B.A. thesis, Harvard Business School, 1975; Robert B. Stobaugh, et al., "Nine Investments Abroad and Their Impact at Home" (Boston: Harvard Business School Division of Research, forthcoming 1976); and Table 2–6 of this report.

[4] Sidney M. Robbins and Robert B. Stobaugh, "Money in Multinational Enterprise" (New York: Basic Books, 1973), Chapter 2.

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TABLE 2-2.—RANK OF U.S. FIRMS AMONG 10 FIRMS WITH LARGEST SALES IN 9 INDUSTRIES, WORLDWIDE EXCLUDING UNITED STATES, 1971

Rank	Food products (20)[1]	Paper and allied products (26)[1]	Chemicals and allied products (28, excluding 283)[1]	Pharmaceuticals (283)[1]	Rubber products (30)[1]	Primary and fabricated metals (33 and 34)[1]	Nonelectrical machinery (35)[1]	Electrical machinery (36)[1]	Automotive (371)[1]	Total number of U.S. firms
1							United States		United States	2
2		United States							United States	2
3					United States		United States	United States		3
4				United Sates	United States					2
5	United States				United States					2
6	United States	United States		United States	United States		United States			5
7	United States	United States	United States		United States		United States			5
8	United States	United States	United States	United States	(2)		United States	United States		6
9	United States	United States	United States		(2)	United States	United States	United States		6
10	United States	United States	United States		(2)	United States		United States	United States	7
Number of U.S. firms in top 10	6	5	4	3	5	2	5	4	3	40

[1] Standard industrial classification of U.S. industries.
[2] No data available.

Note: No entry in table equals foreign firm.

Source: Fortune, as listed in table 2-1, except U.S. sales subtracted from worldwide sales; U.S. sales estimated from published data and industry interviews. For further explanation and for list of companies, see report attached to testimony of Robert B. Stobaugh before the Committee on Ways and Means, U.S. House of Representatives, June 11, 1975, table A-2.

TABLE 2-3.—SELECTED DATA ON SALES OUTSIDE THE UNITED STATES OF LARGEST U.S. AND NON-U.S. FIRMS, 9 SELECTED INDUSTRIES, 1971

	Food products (20)[1]	Paper and allied products (26)[1]	Chemicals and allied products (28, excluding 283)[1]	Pharmaceuticals (283)[1]	Rubber products (30)[1]	Primary and fabricated metals (33 and 34)[1]	Nonelectrical machinery (35)[1]	Electrical machinery (36)[1]	Automotive (371)[1]
Number of foreign firms with sales larger than those of largest U.S. firm	4	1	6	3	2	8	0	2	0
Sales of largest foreign firm (billions of dollars)	6.4	.63	3.3	.29	2.2	2.8	.79	4.6	3.9
Sales of largest U.S. firm (billions of dollars)	.41	.59	.96	.22	1.1	.89	1.1	3.4	4.1
Ratio of sales of largest foreign firm to largest U.S. firm	15.6	1.1	3.4	1.3	2.0	3.1	.72	1.4	.95

[1] Standard industrial classification of U.S. industries.

Source: As table 2-2.

U.S. Multinational Enterprises Compared With Non-U.S. Multinational Enterprises: Sales Outside Their Respective Home Countries

The classification of a firm as a multinational enterprise is somewhat arbitrary, and good data on their activities are difficult to obtain. We have used the definitions formulated by the Multinational Enterprise Project at the Harvard Business School and their data on the 187 U.S. firms and the 209 non-U.S. firms classified as multinational enterprises.[5] As sales data are available only on the basis of all manufacturing industries aggregated, we cannot use the data to draw conclusions about competitive conditions within an industry. Still the data are useful as a measure of the capability of non-U.S. firms to operate across national boundaries relative to that of the U.S. firms. Furthermore, there is some evidence that direct investment by non-U.S. multinationals tends to occur mostly in industries in which U.S. multinationals operate.[6]

The U.S. enterprises, on the average, are smaller than the foreign enterprises when compared on the basis of the total sales of foreign manufacturing affiliates. The U.S. average was $349 million, the non-U.S. average $395 million (for 1970, the only year for which data are available; see Table 2-4). Furthermore, as the U.S. enterprises had a slightly greater number of foreign affiliates than did the non-U.S. enterprises (29 versus 27), the average sales of a foreign affiliate are smaller for the U.S. enterprises than for the non-U.S. ones ($12 million versus $15 million).

TABLE 2-4.—A COMPARISON OF THE SALES AND NUMBER OF FOREIGN[1] MANUFACTURING AFFILIATES OF U.S. VERSUS NON-U.S. MULTINATIONAL ENTERPRISES, 1970

[Dollar amounts in millions]

	U.S. multinational enterprises	Non-U.S. multinational enterprises
Total number of enterprises	187	209
Sales of all enterprises outside their respective home countries:		
Total, all enterprises	$65,300	$82,500
Average per enterprise	$349	$395
Number of manufacturing affiliates owned by enterprise outside their respective home countries:		
Total, all enterprises	5,490	5,640
Average per enterprise	29	27
Average sales per affiliate	$12	$15

[1] In this context, "foreign" means outside home country of multinational enterprise in question.

Source: Table A-2, appendix.

INDIVIDUAL PRODUCTS IN INDIVIDUAL COUNTRIES

It would be desirable to know the total sales of each important seller within the boundaries of each market for each product line in which U.S. affiliates are competing. But such data are difficult to obtain, for they are considered by companies to be confidential and are seldom published. Within the time and budget limitations of this study, we were able to obtain, through confidential interviews with U.S. firms, data on market shares in six well-defined product

[5] James W. Vaupel and Joan P. Curhan, "The World's Multinational Enterprises" (Boston: Harvard Business School Division of Research, 1973), pp. 2-3. This project initially collected data on U.S. firms and subsequently on non-U.S. firms. Based on the initial experience, the definition of a non-U.S. multinational enterprise is slightly different from a U.S. one. Furthermore, more extensive data were collected for the non-U.S. firms—hence, U.S. firms had to be supplemented with the project's data on data from other sources. But as discussed in the notes to Tables A-2 in the Appendix, we believe that the use of comparable samples and perfect data would be very unlikely to change our basic conclusions.

[6] See reference 3, this chapter.

lines in the 15 countries in which the bulk of U.S. foreign direct investment in manufacturing exists.[7] For each of these product lines we attempted to obtain the following data for each country for 1971: (1) the size of the market, (2) the sales in the market of each of the major companies selling into the market, and (3) the nation in which each of the major companies is headquartered. We were able to accumulate sufficiently complete data to allow an analysis of 59 out of the 90 cells of data potentially available; i.e., six product lines in 15 countries.

On the average, the market share of the largest U.S.-owned affiliate in each market was 80 percent of that of its largest foreign competitor. Furthermore, as shown in Table 2-5, U.S.-owned affiliates had the largest market share in only 39 perecnt of the situations. Conversely, at least one foreign competitor had the largest market share in 61 percent of the cases. And most of these 61 percent were multinational enterprises—again providing evidence that the main competitors to American firms abroad are other multinational enterprises rather than strictly local firms. We, of course, do not know how representative this sample is. However, the fact that the 15 countries selected are those in which U.S. manufacturing activities are concentrated might well mean that the sample is biased in the direction of making U.S.-owned acivities appear relatively larger than is actually the case.

TABLE 2-5.—CATEGORIES OF COMPANIES WITH LARGEST MARKET SHARES IN 90 PRODUCT-COUNTRY MARKETS (6 PRODUCT LINES IN 15 COUNTRIES), 1971[1]

	Number	Percentage
Foreign affiliate of U.S. firm	23	39
Non-U.S. firm	36	61
Multinational enterprises	[2] 29	49
Nonmultinational enterprises	7	12

[1] With 6 products and 15 countries, there is a possible total of 90 product-country markets. However, data on only 59 of these were available to us. The product lines are automotive, diesel engines, ethical drugs, steam generators, tires, and wheeled tractors. The countries are Argentina, Belgium, Brazil, Canada, France, Iran, Italy, Mexico, Netherlands, Spain, Switzerland, Turkey, United Kingdom, Venezuela, and West Germany.

[2] Of these operations, 9 (15 percent) were inside and 20 (34 percent) were outside the home country of the multinational enterprise in question; thus, in 27 percent of the situations, a home-country firm had the largest market share.

Source: Interviews with headquarters of U.S. multinational enterprises. Supporting details are shown in report attached to testimony of Robert B. Stobaugh before the Committee on Ways and Means, U.S. House of Representatives, June 11, 1973, table A-3.

A Dynamic View: Growth From 1971 to 1973

The only evidence available to us allows but two comparisons of the growth of U.S. firms compared with their foreign competitors since 1971.

The first of these is for the 90 firms—43 U.S. and 47 non-U.S.—that were the ten largest firms in each of nine industries in 1971 in terms of worldwide sales *including* those in the United States. Whereas, in 1971 U.S. firms (including their U.S. sales) were largest in seven of the nine industries (Table 2-1), by 1973 they ranked largest in only four of the same nine industries (Table 2-6). And the number of U.S. firms in the top half of each industry (that is, the first five ranks) dropped from 27 to 1971 to 23 by 1973. Furthermore, the average sales increase for the non-U.S. firms was higher than that of the U.S. firms in each of the nine industries (Table 2-7).

[7] These 15 countries for which we were able to get data are: Canada, Belgium, France, Germany, Netherlands, Italy, Spain, Switzerland, United Kingdom, Argentina, Brazil, Mexico, Venezuela, Iran and Turkey. This list of countries came from Peggy Musgrave, "Tax Preference to Foreign Investment," in Joint Economic Committee, 92d Congress, 2d Session, "The Economics of Federal Subsidiary Programs"; a compendium of papers (Washington: U.S. Government Printing Office, 1972), Part 2—International Subsidies.

TABLE 2-6.—RANK IN 1973 OF U.S. FIRMS AMONG 10 FIRMS WITH LARGEST SALES IN 1971 IN 9 INDUSTRIES, WORLDWIDE INCLUDING UNITED STATES

Rank	Food products (20)[1]	Paper and allied products (26)[1]	Chemicals and allied products (28, excluding 283)[1]	Pharmaceuticals (283)[1]	Rubber products (30)[1]	Primary and fabricated metals (33 and 34)[1]	Nonelectrical machinery (35)[1]	Electrical machinery (36)[1]	Automotive (371)[1]	Total number of U.S. firms
1					United States		United States	United States	United States	4
2		United States	United States	United States		United States	United States	United States	United States	7
3	United States	United States		United States	United States		United States		United States	6
4		United States					United States	United States		3
5	United States				United States	United States				3
6	United States	United States	United States	United States	United States					5
7	United States	United States			United States		United States			4
8	United States	United States		United States			United States	United States		5
9	United States		United States	United States						3
10			United States	United States			United States			3
Number of U.S. firms in top 10	6	6	4	6	5	2	7	4	3	43

[1] Standard industrial classification of U.S. industries.

Note: No entry in table equals foreign firm.

Source: For list of firms, see table A-1 in appendix.

TABLE 2-7.—CHANGE IN WORLDWIDE SALES, INCLUDING THOSE IN THE UNITED STATES, FROM 1971 TO 1973 OF 10 LARGEST FIRMS, (BOTH UNITED STATES AND NON UNITED STATES IN EACH OF 9 INDUSTRIES

Industry	Increase in total sales (percentage) U.S. firms	Non-U.S. firms
Food products (20)	25	50
Paper and allied products (26)	40	243
Chemicals and allied products (28, excl. 283)	32	52
Pharmaceuticals (283)	25	41
Rubber products (30)	28	46
Primary and fabricated metals (33 and 34)	41	47
Nonelectrical machinery (35)	39	40
Electrical machinery (36)	43	57

Note: The 10 firms in each industry were chosen on the basis of 1971 sales. (#)=Standard industrial classification of U.S. industries.

Source: As table 2-6; for a list of firms and their sales from which growth rates calculated, see table A-1 in appendix.

The other information source provides still another clue about the relative growth of U.S. multinationals and their rivals—data on the book value of all foreign direct investment, regardless of industry, of multinationals encountered in four foreign countries—United Kingdom, Switzerland, West Germany, and Japan. We do not have comparable data available for other foreign countries, but it has been estimated that, excluding U.S.-based foreign direct investment, these four foreign countries accounted in 1967 for about 59 percent of all foreign direct investment and ranked first, third, fifth and tenth respectively among the ranks of countries.[8] The foreign activities of firms headquartered in these four nations grew much faster than the foreign activities of U.S.-based firms—51 percent for the non-U.S. firms versus 24 percent for the U.S.-based ones, see Table 2-8 (there is growth over a two-year period, thus, the average annual growth rates are 28 percent and 11 percent respectively).

* * * * * * *

To be sure, this has not been an exhaustive study of the subject, but only a study of readily available information. Certain biases might exist. For example, some non-U.S. firms might have relatively more trading operations than U.S. firms and thus appear much bigger by a measure of sales than if another measure of size—such as fixed assets—were used. On the other hand, the size of some foreign firms might well understate their advantage over U.S. firms because many non-U.S. firms gain an additional source of competitive strength through their close links with financial institutions.[9]

TABLE 2-8.—GROWTH IN BOOK VALUE OF FOREIGN DIRECT INVESTMENTS BY PRIVATE FIRMS OF SELECTED COUNTRIES, 1971 TO 1973

[Billions of equivalent U.S. dollars unless otherwise noted]

Country in which firms headquartered	1971	1973	Growth 1971 to 1973 (percentage)
United Kingdom	$23.7	$30.4	
Switzerland	9.7	14.3	
West Germany	6.2	11.0	
Japan	3.7	9.5	
Total, above 4 countries	43.3	65.2	51
United States	86.2	[1] 107.3	24

[1] Preliminary.

Source: For foreign countries, unpublished data from Bank of England and United Kingdom Central Statistical Office Union Bank of Switzerland, Deutsche Bundesbank, and Japan External Trade Organization and used by "Business Week" for chart on page 65, July 14, 1975; United States data from "Survey of Current Business" (August 1974), pt. 11, p. 16, and Ibid. (September 1973), p. 24.

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[8] This ignores foreign direct investment by firms headquartered in developing countries and thus is on the high side. However, the bias probably is not great. Calculated from United Nations, "Multinational Corporations in World Development" (New York: United Nations, Department of Economic and Social Affairs, 1973), p. 148.

[9] Hymer and Rowthorn, "Multinational Corporations," op. cit., p. 64.

But until a more exhaustive study is done, we will rely on our many different glimpses of the phenomenon, for all of these glimpses support a consistent view. That is, U.S. firms face powerful foreign competitors, and these competitors seem to be larger than their U.S. counterparts and growing faster.

The fact that the largest non-U.S. multinational enterprises seem to be growing faster than the largest U.S. multinationals is a continuation of trends observed for 1962 to 1967 by Stephen Hymer and Robert Rowthorn.[10] They offered two possible explanations to explain this finding: First, European governments were actively taking positive measures to strengthen their large corporations.[11] Second, the non-U.S. firms were smaller during that time; and smaller firms—both U.S. and non-U.S.—grew faster than the largest firms within any one industry.[12]

The statistics in our study seem to break new ground in that the largest non-U.S. firms still are growing faster than their U.S. rivals *even though these non-U.S. firms have passed their U.S. rivals in size.* We did not seek to determine the reasons for this; such a study was beyond our scope. To be sure, the faster growth worldwide (including U.S. sales) between 1971 and 1973 of foreign enterprises vis-à-vis the U.S. firms (as shown in Table 2-7) can be partially accounted for by the fact that foreign firms have a greater share of their sales outside the United States and these sales were inflated because of the revaluation of foreign currencies relative to the U.S. dollar. However, there is no apparent way that this could account for the faster growth of non-U.S.-owned foreign direct investment (as shown in Table 2-8), because the U.S. activities of U.S. firms are *excluded* in this comparison, whereas the U.S. activities of foreign firms are *included.* It could be that the Hymer and Rowthorn were correct—the aid that the home countries of non-U.S. multinational enterprises give these firms could provide a partial explanation.[13] For example, although the published tax rates faced by non-U.S. multinationals are comparable to published U.S. tax rates,[14] there is some evidence that foreign tax authorities are more lenient with the multinationals headquartered within their jurisdiction than are the U.S. tax authorities with U.S.-based multinationals.[15]

This subject of aid to multinationals by their home governments is an area that should be studied to provide information to U.S. policymakers. In the meantime, based on data in this chapter, we conclude that on the average U.S. foreign direct investors face competitors that are as large as they, both on a worldwide basis as well as in individual foreign countries. We use this conclusion as an aid in constructing the simulation model, described in Chapter 5, that we employ to estimate the effects on the U.S. economy of placing a U.S. tax on the unremitted foreign earnings of U.S. companies.

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[10] Ibid., p. 70.

[11] Ibid., p. 73. For a further discussion of assistance by European governments to large companies headquartered within their boundaries, see Raymond Vernon (ed.) "Big Business and the State" (Cambridge, Mass.; Harvard University Press, 1974). Vernon is skeptical about the effectiveness of European governmental policies to date in developing high-technology industries, primarily because of their focus on domestic rather than worldwide market (Ibid., p. 20); but he recognizes that state encouragement might have been one of the factors motivating European firms to invest abroad, especially in industries heavily dependent on raw materials (Ibid., p. 22).

[12] Hymer and Rowthorn, "Multinational Corporations," op. cit., p. 70. This reason is consistent with the idea that U.S. firms are leaders in product innovation, but that foreign firms, through copying or adapting U.S. products, gradually "catch up" with their U.S. counterparts as technology becomes more standardized within an industry. For an example of this loss of industry position by U.S. firms as technology matures in the petrochemical industry, see Robert B. Stobaugh, "The Product Life Cycle, U.S. Exports, and International Investment," unpublished D.B.A. thesis, Harvard Business School, 1968. For a discussion of the role of the product life cycle in foreign direct investment, see Raymond Vernon, "Sovereignty at Bay," op. cit., Chapter 3.

[13] See reference 11, this chapter.

[14] National Foreign Trade Council, Inc. "Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad," New York 1972; and Arthur Andersen & Co., "Comments Regarding Proposed Regulations 1.861-8 and Analysis of their Effect on Competitive Position of United States International Business," mimeograph, Nov. 15, 1973.

[15] This is my impression on interviews with both U.S. and non-U.S. multinational enterprises. Also, see Arthur Andersen & Co., op. cit. Furthermore, some are headquartered in nations that do not place a tax on profits repatriated from abroad; see Carl S. Shoup, "Taxation of Multinational Corporations," in "The Impact of Multinational Corporations on Development and on International Relations; Technical Papers: Taxation" (New York: Department of Economic and Social Affairs, United Nations, 1974), p. 36.

Chapter 3

THE RATE OF FOREIGN TAXES ON U.S. MANUFACTURING OPERATIONS ABROAD

In order to estimate the effect that a change in U.S. tax laws would have on U.S. manufacturing operations abroad, one must have an estimate of the total tax payments—those paid to foreign governments as well as to the U.S. government—that exist under current U.S. tax laws compared with what would exist if these laws were changed. Thus, an estimate of the rate at which foreign governments tax the profits and dividends of U.S.-owned affiliates abroad is needed.

An estimate of the relevant tax rates is not easy to obtain. Countries publish a schedule of nominal tax rates but these are not useful for our purposes because taxes actually paid by companies can deviate widely from the nominal rates. Furthermore, some published sources of taxes paid include data on all U.S. affiliates, including two categories of affiliates that would not be affected by a U.S. tax on unremitted earnings: (1) those paying foreign tax rates greater than 48 percent, and (2) those operating at a loss.[1]

We know of only one source of data that eliminates these two categories of affiliates and thus reports foreign tax rates only for those U.S.-owned foreign affiliates that would be affected if the U.S. government placed a tax on the unremitted foreign earnings of U.S. affiliates abroad. This source is an unpublished tabulation by the Department of Commerce of data collected as part of the latest (1966) survey of all U.S. owned-foreign affiliates.[2] These figures are shown in Table 3–1, which also presents information on some of the individual countries in which substantial amounts of U.S. foreign direct investment have been placed.

Those manufacturing affiliates that would be affected by the taxation of unremitted foreign earnings were, on the average worldwide in 1966, paying a foreign income tax rate of 33 percent (column 3 of Table 3–1). They, in turn, were remitting dividends to the United States equal to 25 percent of their net income after foreign income taxes (column 7 of Table 3–1). These dividends were subjected to a withholding tax of 9 percent by the foreign governments (column 6 of Table 3–1.)[3] These estimates are used in our computer simulation discussed in Chapter 5.

For the fifteen countries the foreign income tax rates varied from a low of 17 percent in Switzerland to a high of 40 percent in Mexico; most of these countries that are members of the Organization for Economic Cooperation and Development (OECD) had an income tax rate of 31 to 36 percent. The dividend withholding tax rate varied from zero in a number of countries to 23.5 percent in Brazil. Tax rates in certain countries which are not shown in the list but which are making a major attempt to attract foreign investments are substantially lower than these. For example, the effective income tax rate in Ireland for all U.S. foreign affiliates was 10 percent (net income was $20 million and income taxes were $2 million).

Because of the exclusion in Table 3–1 of affiliates either paying more than a 48 percent income tax or not earning a profit, the tax rates in this table differ substantially from results reported elsewhere. For example, the inclusion of *all* manufacturing affiliates, regardless of whether they earned a profit or what their tax rate was, would result in a tax rate of 46 percent rather than 33 percent.[4] Furthermore, the tax rates shown in Table 3–1 differ substantially from nominal tax rates published elsewhere; the United Kingdom, for example, has a tax rate of 36.4 percent compared with a reported nominal rate of 45.00 percent.[5]

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[1] For example, see Table 3 of U.S. Department of Commerce, Bureau of Economic Analysis, "Special Survey of U.S. Multinational Companies, 1970," November 1972.

[2] Special computer run by George R. Kruer, Acting Chief, International Investment Division, and Smith W. Allnutt III, Chief, Data Retrieval and Analysis Branch, Bureau of Economic Analysis, Social and Economic Statistics Administration, U.S. Department of Commerce, Washington, D.C., Apr. 11, 1973. For a recent estimate that excludes subsidiaries operated at a loss but includes those paying foreign tax rates greater than 48 percent, see M. E. Kyrouz, "Foreign Tax Rates and Tax Bases," National Tax Journal (March 1975), pp. 61–80.

[3] The divident payout rate for all U.S. foreign direct investment was 56 percent in 1970, see U.S. Department of Commerce, "The Multinational Corporation" (Washington: Superintendent of Documents, 1972), Part 3, Table IB, p. 34.

[4] See U.S. Department of Commerce, "Special Survey," op. cit., p. 22.

[5] National Foreign Trade Council, Inc. "Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad," New York 1972, p. 9.

TABLE 3-1.—FOREIGN INCOME TAX RATES AND FOREIGN DIVIDEND TAX RATES FOR U.S.-OWNED FOREIGN AFFILIATES WHOSE TAXES WOULD BE AFFECTED IF A U.S. TAX RATE WERE PLACED ON THEIR UNREMITTED FOREIGN EARNINGS: SELECTED COUNTRIES AND WORLDWIDE TOTALS FOR AFFILIATES IN MANUFACTURING, 1966

Country	Net income (millions) (1)	Foreign income taxes (millions) (2)	Foreign income tax rate (percent) (3)	Total dividends (millions) (4)	Total dividend payout rate (percent) (5)	Foreign dividend taxes (millions) (6)	Foreign tax rate on dividends (percent) (7)	Number of reporting affiliates (8)
Selected OECD countries:								
Canada	$487	$176	36.1	$58	18.7	$8	13.8	979
Belgium-Luxembourg	77	25	32.5			(1)		150
France	66	24	36.4			(1)		126
Germany	248	80	32.3	78	46.4	15	19.2	263
Italy	77	24	31.2			(1)		163
Netherlands	81	29	35.8	10	19.2	0	0	171
United Kingdom	674	245	36.4	162	37.8	0	0	825
Australia	184	67	36.4	37	31.6	5	13.5	349
Japan	59	20	33.9			(1)		111
Other European countries:								
Spain	62	15	24.2	3	6.4	0	0	106
Switzerland	69	12	17.4	6	10.5	0	0	92
Latin American countries:								
Argentina	148	51	34.5	19	19.6	0	0	133
Brazil	181	50	37.6	17	13.0	4	23.5	204
Mexico	178	72	40.4	18	17.0	2	11.1	454
Venezuela	57	18	31.6	11	28.2	0	0	157
Worldwide	3,025	997	33.0	515	25.4	46	8.9	5,472

[1] Data suppressed by Department of Commerce. Table excludes affiliates with negative income because no U.S. tax would be due. It also excludes affiliates with an income tax rate greater than 48 percent, as measured by income taxes plus dividend taxes divided by net income before these taxes. (A combination of taxes on income and dividends often results in a local tax rate greater than 48 percent.) Our assumption is that any change in U.S. tax law to place a tax on the unremitted foreign earnings of U.S. affiliates would not change the provisions for a foreign tax credit; thus, any U.S.-owned foreign affiliate that pays a foreign tax rate of 48 percent or higher would not be affected.

Note: Col. 1 is the net income of the affiliate after expenses but before taxes. Col. 2 is the provision for foreign income taxes as carried on the affiliates' income statement. Col. 3 is income taxes (2) divided by net income before income taxes (1). Col. 4 is the total of common and preferred dividends remitted to the United States prior to withholding taxes. Col. 5 is the total dividends (4) divided by the figure obtained by subtracting income taxes (2) from net income (1). Col. 6 is the amount of foreign taxes withheld on dividends remitted to the United States. Col. 7 is the dividend taxes (6) divided by the total dividends (4). The countries listed separately were selected by the Department as having received relatively large amounts of U.S. foreign direct investments.

Source: Special computer run by George R. Kruer, Acting Chief, International Investment Division, and Smith W. Allnutt III, Chief, Data Retrieval and Analysis Branch, Bureau of Economic Analysis, Social and Economic Statistics Administration, U.S. Department of Commerce, Washington, D.C., Apr. 11, 1973.

CHAPTER 4

POSSIBLE REACTIONS OF AFFECTED ORGANIZATIONS

Any actions taken by the U.S. government might cause reactions by the organizations affected—the U.S. multinational enterprises and foreign governments.

U.S. MULTINATIONAL ENTERPRISES

It is possible that increases in U.S. taxation would cause some U.S. multinational enterprises to reorganize their corporate structures and become wholly or partly expatriate firms. Any such extensive corportae reorganization would in turn reduce the amount of U.S. taxes collected by the taxation of unremitted foreign earnings of U.S.-owned operations abroad. J. L. Kramer and G. C. Hufbauer, in a recent article, studied a hypothetical U.S. firm, for which they provided figures made up of a composite of four large U.S. multinational companies, one each from the auto industry, the petroleum industry, the retailing industry, and the banking industry.[1] They concluded that through some type of reorganization, "the composite firm would probably respond to major increases in the U.S. tax burden on foreign income."[2] Furthermore, several companies have discussed with us the possibility of undertaking a study for them to determine the feasibility of such a move.

But because of the great uncertainty that surrounds this issue, we assume for the simulation model in Chapter 5 that no U.S. corporate reorganization would occur.

FOREIGN GOVERNMENTS

There are many ways that foreign nations could change their tax laws so as to selectively tax U.S. affiliates in order to obtain most of the increased tax revenues that would be paid by U.S. firms as a result of placing a U.S. tax on unremitted earnings.

One method would be to treat any unremitted earnings taxed by the U.S. government as though they had been paid as dividends, and thus subject them to a dividend withholding tax.[3]

A second alternative available to the foreign government is to increase its withholding tax on dividends. By restricting the increase to dividends paid outside the host country, this method would not have to be discriminatory toward specific companies nor subject local companies to increased taxes. Of course, affiliates of non-U.S. multinational enterprises would be subject to the increased taxes on their dividends, but this would be a substantially lower tax load than paid by U.S. affiliates, which would be subject to U.S. tax rates on all income regardless of the amount paid out in dividends.

In fact, given certain assumptions about the remittance behavior of U.S. firms, a foreign government could increase dividend taxes in order to obtain all of the taxes paid by U.S. affiliates, thereby reducing U.S. revenues below the level existing under current laws. A simple example of the concept follows: If under current law, a U.S.-owned foreign affiliate is paying no foreign income tax and no foreign dividend withholding tax and is remitting half of its earnings to the United States, the United States receives 48 percent of half of the earnings, which is equivalent to 24 percent of the total earnings. If a tax were placed on unremitted earnings and no other changes took place, then the U.S. would tax all undistributed earnings at 48 percent. But if the foreign government imposed a dividend tax of 48 percent and the U.S.-owned affiliate paid out all its earnings, then U.S. taxes would drop to zero. Hence, the effective U.S. tax rate on all earnings would have dropped from 24 percent to zero. (In the next chapter a rationale will be offered to explain why U.S. firms might choose to remit all of their foreign earnings in the year earned.)

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[1] J. L. Kramer and G. C. Hufbauer, "Higher U.S. Taxation Could Prompt Changes in Multinational Corporate Structure," International Tax Journal (August 1975), pp. 301–324.
[2] Ibid., p. 324.
[3] This idea was suggested to me by G. C. Hufbauer, Director, International Tax Staff, U.S. Treasury.

As part of this study, we interviewed the commercial representatives of eleven foreign nations, six developed and five less-developed, in order to obtain their reactions to the U.S. proposal to tax unremitted foreign earnings of U.S. firms operating abroad. In many cases, there was a lack of awareness of the issues related to taxation of foreign income, and most particularly, the issue of taxing unremitted earnings. These representatives were concerned, for the most part, primarily with the trade effects of proposed U.S. legislation and not the effects of proposed tax changes.

Although none of the commercial attachés could provide an official government position, some openly discussed their personal reactions to the proposed U.S. tax on unremitted earnings. The tax proposal was viewed as a vehicle whereby foreign subsidiaries could be used to impose an American economic policy on a foreign country regardless of that country's needs or national objectives, for an American policy of taxing undistributed profits would defeat the purpose of tax incentives granted by host countries.[4] In fact, we know from past history that the United States often has extended its reach into the domain of another government to affect the activities of affiliates controlled by U.S. parents. Sometimes the U.S. government has been successful, sometimes not.[5]

A number of attachés suggested that a reaction of some sort by their governments to such a tax policy would be in order. This was particularly true among those from less-developed countries. They thought it possible to raise the foreign income tax rate on U.S. affiliates, thereby decreasing the U.S. government proceeds to a level equivalent to or below that existing prior to the placing of a U.S. tax on unremitted earnings. And some thought that this could be done without putting an added tax burden on local companies and non-U.S. multinationals as well—the tax could be structured in a discriminatory fashion against U.S. companies. In fact, the economic representative of one major European country felt it would be possible to structure and pass legislation to that effect by judicious wording, or, alternatively, for the tax authorities to accomplish this goal through administrative action.

Our interviews were unstructured after an opening question by the interviewer. Whether, and if so to what extent, the person being interviewed was influenced by the interviewer, we do not know. Furthermore, in spite of the comments made by the commercial attachés, it is possible that the reactions of foreign governments would be minimal or non-existent. We do not know. Therefore, we assume for the simulation model in Chapter 5 that no such actions would occur.

CHAPTER 5

ESTIMATES OF THE EFFECT ON THE U.S. ECONOMY OF TAXING THE UNREMITTED EARNING OF U.S. MANUFACTURING SUBSIDARIES ABROAD

We know of no study to date that purports to show the long-run competitive effects that a change in U.S. tax laws would have on the foreign operations of U.S. companies.[1] Yet we believe that such competitive effects must be taken into account by policymakers.[2] Thus, we have designed, constructed, and operated a computer model that simulates such results over a 15-year period.[3] This model explicitly considers the "experience curve" effects if U.S. firms expand overseas at rates different from those of their foreign rivals.[4]

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[4] For a protest from Ireland, see "For Stay-At-Home," The Economist, June 9, 1973.

[5] For a discussion of the general jurisdictional issue, see Raymond Vernon, "Sovereignty at Bay" (New York: Basic Books, 1971), Chapter 7.

[1] For example of models that do not consider the long-run competitive efforts, see Peggy Musgrave's testimony before the Ways and Means Committee, U.S. House of Representatives, Feb. 28, 1973, and J. L. Kramer and G. C. Hufbauer, "Higher U.S. Taxation Could Prompt Changes in Multinational Corporate Structure," International Tax Journal (August 1975), pp. 301–324.

[2] For a discussion of the importance to policymakers of considering the long-run competitive effects of U.S. regulations, see Raymond Vernon, "U.S. Controls on Foreign Direct Investment—A Reevaluation" (Financial Executives Research Foundation, 1969).

[3] This model was constructed and operated by William F. Samuelson. The other three collaborators worked on the other aspects of the study.

[4] For those readers who need further inmormation about the "learning curve," see Robert B. Stobaugh and Phillip L. Townsend, "The Impact of Price Forecasting on Strategic Planning: The Case of Petrochemicals," Journal of Marketing Research (February 1975), pp. 19–29.

A long line of research supports this concept of an "experience curve," which in effect is a shorthand definition for two factors that reduce costs. First, there is the absolute size of the operation—such economies of scale are called "static scale economies" because they depend on size at a given time. Second, there is the "learning curve" effect, in which more experience results in more efficient operations—these scale economies are called "dynamic scale economies," for they take place over time. The relative importance of these two scale economies—static and dynamic—varies from industry to industry. However, a body of evidence exists to suggest that a reasonable assumption for a wide variety of industries is that unit costs decline 20 percent in constant dollars for each doubling of cumulative production,[5] and this is the estimate used in our simulation model. Of course, the fact that the declines are expressed in terms of a constant percentage means that the declines in absolute terms become smaller. A simple example: if it costs $1 to produce unit number 1, then it would cost 80¢ to produce unit number 2—a saving of 20¢ per unit. But it would cost 64¢, (i.e., 80% of 80¢) to produce unit number 4—a reduction of only 16¢.

The "experience curve" is of critical importance in any analysis of long-range competitive effects. Because to the extent that higher U.S. taxes prevent U.S. subsidiaries abroad from expanding as rapidly as their foreign competitors, then the costs of the foreign competitors gradually become lower than the costs of the U.S. subsidiaries. For example, take a U.S. subsidiary and a foreign competitor with equal output and equal production experience and assume that the foreign competitor begins to expand more rapidly than the U.S. subsidiary. When the foreign firm gets a slight edge over the U.S. subsidiary in the rate of increase of cumulative production, the unit costs of the foreign firm decrease by a greater amount; consequently it makes a greater profit than the U.S. subsidiary. The foreign firm reinvests part of its increased earnings to increase production capacity, so its output in the next year increases by a greater amount than that of the U.S.-owned subsidiary, whose reinvestment is limited by smaller profits. Again, the production edge of the foreign firm is translated into larger cost declines, which means a greater profit margin. As each year passes, the difference in unit production and unit costs between the two firms continues to widen. Eventually, the foreign competitor is earning a profit while the U.S. subsidiary is operating at a loss.

Although experience curves typically are applicable to a product line, we apply the concept to all U.S. operations abroad. We do this by assuming that all U.S. subsidiaries which are engaged in manufacturing abroad can be adequately represented by one "typical"subsidiary, with one product line.[6] Similarly, all foreign competitors of this U.S.-controlled subsidiary can be adequately represented by one "typical" foreign competitor, which is a subsidiary of a non-U.S. multinational enterprise. Obviously this is a gross simplification because as indicated in Chapter 2, in a typical foreign market there are a number of U.S.-owned affiliates competing with each other and with a number of non-U.S. companies. Thus, some U.S. subsidiaries in the real world are likely to have more favorable results than our model indicates and others less favorable.

Like all models, ours is an abstraction of reality. But in this case we are making the first attempt to build a model of a very complex phenomenon. The purpose of the model is merely to illustrate the importance of "experience curve" effects rather than to provide an unequivocal quantitative estimate of these effects. In fact, our assumptions dictate the direction of the results.

To gain the best sense of a possible range of outcomes, we not only simulated a "base case" but also seven other cases in which we varied certain critical assumptions. We take some comfort in the fact that the quantitative results for most of the cases are in a fairly narrow range. We present the results of our

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[5] "Perspectives on Enterprise" (Boston: Boston Consulting Group, 1968); and Stobaugh and Townsend, "The Impact of Price Forecasting on Strategic Planning."

[6] Both subsidiaries and branches are affiliates. Subsidiaries are incorporated in a foreign country; branches are not. Some 96 percent of income from foreign manufacturing affiliates is from subsidiaries, see Department of Commerce, "U.S. Direct Investments Abroad, 1966"; Part I, Balance of Payments Data (Washington, D.C.: Superintendent of Documents, 1970), p. 110.

model now because policymakers are considering the issue now. Furthermore, as others might want to test the effects of still different assumptions, we have made the details of the model available for use by anyone.[7]

Because the output from a model depends on the assumptions built into the model, we have listed in some detail the most important assumptions. But not all readers will be interested in the same degree of detail, so some might wish to omit or just skim the next section entitled "Assumptions," and go immediately to the section entitled "Results."

In each of our cases, we compare the results under two conditions: (1) U.S. tax laws on foreign-source income remain unchanged; and (2) U.S. tax laws are changed so as to tax the unremitted earnings of U.S.-controlled foreign subsidiaries (the reader will recall that this change often is referred to as the "elimination of deferral" of U.S. income tax on foreign earnings.) The results are expressed as changes in U.S. tax revenues and in U.S. balance of payments. Because the model would have become too complex at this time, we did not include certain of the effects of U.S. foreign direct investment that we discussed in Chapter 1—the number of jobs associated with U.S. foreign direct investment and resultant increases in skill levels and income levels.

ASSUMPTIONS

ASSUMPTIONS THAT REMAIN UNCHANGED FOR ALL CASES

1. At the present time, without any changes in U.S. taxes on foreign-source income, the U.S.-owned subsidiary and its foreign competitor are at a competitive equilibrium that will remain unchanged over time; that is, they are of equal size now and will remain that way as each grows. Hence, the simulation of the U.S.-owned subsidiary is identical to that of its foreign competitor. Explicitly, the U.S.-owned subsidiary and its foreign competitor are identical in the following ways:

a. *Annual sales volume and net worth.*[8] On this score, the model results probably are more favorable to the U.S.-owned subsidiary than is actually the case—the data in Chapter 2 suggest that on the average U.S. subsidiaries abroad meet foreign competitors that are larger than they.

b. *Costs, and thus profits.* We assume that profits before taxes are 18% of net worth, in accordance with the unpublished data obtained from the U.S. Department of Commerce and partially reported in Chapter 3. Although some data indicate that U.S. subsidiaries are more profitable than their competitors headquartered in the host country,[9] we have no information about the profit rates of foreign subsidiaries of non-U.S. multinational enterprises.

c. *Rates of taxation.* The U.S. tax rate on dividends paid by the U.S.-owned foreign subsidiary is 48 percent, with a U.S. tax credit allowed for foreign taxes on income and dividends. This is obviously a gross simplification, for U.S. laws on taxation of foreign income are so complex that volumes have been published describing and interpreting them.[10] In our model, provisions were not made for other subsidiaries in the system that are either paying more than 48 percent income tax or are not earning a profit. Neither were provisions made for holding companies or Western Hemisphere Trade Corporations. Although some data suggest that U.S. subsidiaries might pay more taxes than do local firms,[11] we have no evidence on this subject for the foreign subsidiaries of non-U.S. multinational enterprises. Neither do we have the rates actually paid by non-U.S. multinational

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[7] See Appendix B of the report attached to my testimony before the Committee on Ways and Means, U.S. House of Representatives, June 11, 1973.

[8] We assumed that the annual production of each is 100 units in year 1.

[9] For example, see John H. Dunning, "U.S. Subsidiaries in Britain and their U.K. Competitors," Business Ratios (Autumn 1966), p. 15.

[10] See Sidney M. Robbins and Robert B. Stobaugh, "Money in the Multinational Enterprise: A Study in Financial Policy" (New York: Basic Books, 1973), Chapter 2.

[11] For example, see the Amcal case in Chapter 7 of Robert B. Stobaugh, et al., "Nine Investments Abroad and Their Impact at Home" (Boston: Harvard Business School, Division of Research, 1976).

enterprises to their home governments, although we assume that foreign-source income is taxed the same in the home country of the non-U.S.-owned subsidiary as for the U.S.-owned subsidiary. In fact, as discussed in Chapter 2, there is some scanty evidence to suggest that such rates are less than those paid by U.S. multinational enterprises.

d. *The two competitors pay the same percentage of earnings as dividends.* We have no data to indicate how realistic this assumption is.

e. *Their costs are affected similarly by accumulated production in the subsidiary.* As indicated above, we assume that unit costs decline 20 percent in constant dollars for each doubling of cumulative production.

f. *They have the same amount of accumulated production experience.*[12] We have no data to indicate how realistic this assumption is.

g. *They reinvest subsidiary earnings and receive new capital outflows from their respective parents to enable the subsidiary to expand net worth at an annual growth rate of 10 percent*;[13] this approximates the historical average of U.S. foreign direct investment for each of the last two decades.[14] (Foreign borrowing does not appear directly in the model, for the financial results are calculated as a percentage of subsidiary net worth.)

2. At the present time, without any changes in U.S. taxes on foreign source income, the U.S. parent and the non-U.S. parent are the same size now and will remain equal as each grows.[15] Hence, the simulation of the U.S. parent is identical to that of the non-U.S. parent.

We further assume thatt he shareholders of the U.S. parent pay an income tax of 30 percent on the dividends received from the parent;[16] an assumption is not needed for the non-U.S. parent, because we do not consider tax revenues of the home country of the non-U.S. parent.

3. If U.S. tax laws are changed to place a U.S. tax on the unremitted earnings of U.S.-controlled foreign subsidiaries, then the following assumptions are made:

a. The growth in the foreign market is not affected by U.S. tax laws. For if the U.S.-owned subsidiary does not expand sufficiently to produce for this foreign market, then the foreign competitor does so.[17]

b. The foreign competitor will maintain the same profit margin per dollar of sales, either because of competition from other foreign competitors or because of its desire to capture market share from the American subsidiary.[18]

c. The U.S. subsidiary will have to lower its prices at the same rate as its foreign competitor (prices are in constant dollars).[19]

d. Both the U.S. parent and the non-U.S. parent expand production in their home country at the same rate regardless of any change in U.S. tax laws.[20] Thus,

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[12] Each subsidiary is assumed to have 775 units of accumulated production experience.

[13] Our base case assumption is that the funds for these new capital outflows are obtained by the parent from royalties and fees received from the foreign subsidiary, profits from exports to the foreign subsidiary, and its new borrowings (both in the United States and abroad). Therefore, dividends from the subsidiary are assumed to be available for dividend payment by the parent to its shareholders. But in the sensitivity analyses, this assumption is changed.

[14] U.S. Department of Commerce, "U.S. Direct Investments Abroad, 1966: Part II: All Industries Summary" (Washington, D.C.: Bureau of Economic Analysis, 1972), pp. 89, 105.

[15] Each parent is assumed to have 1,500 units of accumulated production experience (in its home country) at the beginning of year 1 and to produce 105 units (in home country) in year 1.

[16] We do not know how accurate this estimate is.

[17] This assumption is supported by the findings in Chapters 1 and 2 concerning the amounts of foreign competition faced by U.S. operations abroad.

[18] The only empirical evidence to support this assumption is circumstantial—foreign competitors apparently have been taking the market share away from American subsidiaries, as discussed in Chapter 2; although the effect of mergers is unknown. Also, the importance of market share is widely recognized; for example, see Carl S. Shoup, "Taxation of Multinational Corporations," in Department of Economic and Social Affairs, "The Impact of Multinational Corporations on Development and on International Relations, Technical Papers: Taxation" (New York: United Nations, 1974), p. 37; and Robert D. Buzzell, B. T. Gale, and R. G. M. Sultan, "Market Share—A Key to Profitability," Harvard Business Review (January–February 1975), pp. 97–107.

[19] This assumption of equality in price is consistent with the findings in Chapters 1 and 2 concerning the amounts of foreign competition faced by U.S. operations abroad.

[20] We assume that each expands in terms of units at 5 percent annually.

investment by the parent in the United States does not change if a U.S. tax is placed on the unremitted earnings of U.S.-owned foreign subsidiaries.[21] Of course it is possible that if higher taxes were placed on the U.S. firm's foreign earnings, then the firm would produce some goods in the United States instead of abroad; that is, U.S. production would be used to provide goods for some part of the market that would have been served by foreign production if present U.S. tax laws remained in effect. This increased output in the United States in turn would lower the costs of the U.S. operation, thereby making the United States even more competitive in the export market. Our model was not constructed to simulate this outcome, thus we have no quantitative estimates to show its possible importance. However, two factors lead us to conclude that our overall results would not be changed drastically by this effect. First, as discussed in Chapter 1, we believe that a relatively low volume of U.S. production can be substituted for foreign production. Second, because of the large amount of cumulated production experience in the United States, additional U.S. production has a smaller impact on unit costs than additional foreign production.

4. The U.S. balance of payments surplus associated with U.S. foreign direct investment is directly proportional to the book value of this investment. This assumption probably understates the loss that would be caused to the U.S. balance of payments if a U.S. tax is placed on the unremitted earnings of U.S.-owned subsidiaries abroad. This is because the U.S. balance of payments is dependent on some factors that are related to the growth of the subsidiary; for example, profits and exports of capital equipment.[22]

CRITICAL ASSUMPTIONS THAT ARE VARIED

1. In the base case, we assume that only 20 percent of the parent's accumulated production reduces the unit costs of the subsidiary.[23] In case 2, we assume that none of the parent's accumulated production reduces the unit costs of the subsidiary; whereas in case 3, we assume that all of it does (as indicated above, we assume in all cases that 100 percent of the subsidiary's output plays a role in reducing the subsidiary's costs).

2. In the base case, we assume that the foreign income tax rate is 33 percent and the foreign dividend tax rate is 10 percent.[24] In case 4, these two percentages are changed to 0 and 10, respectively, and in case 5 to 28 and 30, respectively. The case 4 percentages simulate certain low-tax countries. The case 5 percentages simulate Brazil and indicate the potentially strong negative impact on U.S. tax revenues of a high tax rate in the host country on dividends.

3. In the base case without a tax change, we assume that each subsidiary reinvests 44 percent of its earnings after local taxes.[25] In the base case with the tax change, we assume that this 44 percent refers to the portion of subsidiary

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[21] This is in accordance with the statement, "One can safely assume a zero net effect on domestic investment when the foreign investment takes place," in U.S. Tariff Commission, "The Multinational Corporation and the World Economy" (Washington, U.S. Government Printing Office, 1973), p. 649.

[22] The magnitude of net accompanying inflows—inflows resulting from receipts of royalties and capital equipment, components and other items, see Robert B. Stobaugh, et al., "Nine Investments Abroad and Their Impact at Home" (Boston: Harvard Business School, Division of Research, 1976), Chapter 8—is estimated to be 9.44 percent of the net worth of the foreign subsidiary in year 1. The additional capital outflows in addition to the earnings of the subsidiary that are reinvested are estimated to be 90 percent of the subsidiary's earnings that are reinvested—this is the amount needed to maintain a 10 percent growth under current tax laws (see reference 14, this chapter). Therefore, the balance of payments net flow is the sum of (1) dividend payments to the United States by the subsidiary, minus (2) any of these dividends that are reinvested, plus (3) 9.44 percent of net worth, minus (4) 90 percent of reinvested earnings. These estimates came from Piero Telesio, "Part I," of Robert B. Stobaugh, Piero Telesio, and Jose de la Torre, "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment, and Changes in Skill Composition of Employment," Occasional Paper No. 4 of Center for Multinational Studies, Washington, D.C., February 1973, p. 6.

[23] We know of no published empirical evidence on this point. This estimate came from a few interviews with U.S. multinational enterprises.

[24] In accordance with data in Chapter 3.

[25] In accordance with reference 3, Chapter 3.

earnings that are reinvested in the subsidiary after all taxes.[26] In case 6, this number is changed to 75 percent.[27]

4. In the base case with a change in U.S. tax laws, we assume that the U.S.-owned subsidiary pays out all of the subsidiary's earnings each year and then receives the appropriate portion of these earnings from headquarters, either in the form of equity or debt, for reinvestment in the subsidiary. This payout of 100 percent of the earnings each year is likely to occur because, as shown later, this action will maximize the enterprise's after-tax earnings should two conditions be met: (1) the enterprise desires to withdraw funds in some subsequent year for which the subsidiary earns no profit, and (2) the local nation taxes a dividend paid from reinvested earnings but allows either a repatriation of capital or debt repayment without a local withholding tax. In contrast, there seems to be no plausible case under which the enterprise would pay higher total taxes by pursuing this policy. In case 7, this is changed to an assumption that the subsidiary only pays out the amounts desired to be retained by the parent.

5. In the base case, we assume that all of the dividends left with the parent after it reinvests a portion of these dividends in the subsidiary are paid as dividends to parent shareholders.[28] In case 8, this is changed to an assumption that only 50 percent of these are paid as dividends to parent shareholders.

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[26] In fact, there is considerable uncertainty concerning the effect of a change in U.S. tax laws on the reinvestment rate. It is widely believed that changes in U.S. taxes on the unremitted earnings of U.S.-owned subsidiaries abroad would affect investment by these subsidiaries; for example, see Shoup (reference 18, this chapter) and Musgrave (reference 1, this chapter). In fact, there is no evidence to indicate exactly what the effect would be.

To be sure, some studies have shown that changes in tax rates have little or no effect on investment policy, but these studies did not include situations in which two rivals were faced with substantially different tax rates. And that would be an important result if the unremitted earnings of U.S. multinational enterprises were subjected to U.S. taxation. Furthermore, it is easy to conclude that in an extreme case, say, U.S. firms are subjected to a 90 percent tax rate and their non-U.S. rivals were subjected to a 10 percent rate, that taxation would make a big difference. But the difference between 48 percent and 40 percent is less certain. But some empirical evidence suggests that many U.S. multinational enterprises, especially the large ones, use a rule-of-thumb for a dividend payment ratio, see Robbins and Stobaugh, "Money in the Multinational Enterprise," p. 79.

Even if a subsidiary is experiencing a loss in its ordinary business, the parent might still elect to keep it alive—it could be useful as a "listening post" to provide information about conditions with foreign markets.

Also, firms respond to the actions of other firms, and in making an investment, a firm not only responds to the previous actions of its competitors, but also must consider the probable response of its competitors to the move. A body of research at Harvard Business School shows the importance of oligopoly in affecting the decision to acquire or create a new subsidiary. "Follow the leader" behavior seems to be important in some instances, see Frederick T. Knickerbocker, "Oligopolistic Reaction and Multinational Enterprise" (Boston: Harvard Business School, Division of Research, 1973), but not in all, see Robert B. Stobaugh, "The Product Life Cycle, U.S. Exports, and International Investment," unpublished D.B.A. thesis, Harvard Business School, 1968, Chapter 5. In addition, the motive, "exchange-of-threat," seems to generate new acquisitions and creations. Exchange-of-threat is when a firm A establishes itself in market B in order to be able to improve its bargaining position relative to firm B in market A. For example, direct investment by European multinationals in the United States tends to occur mostly in those industries in which U.S. multinationals invest heavily in Europe; see Edward M. Graham "Oligopolistic Imitation and European Direct Investment in the United States," unpublished D.B.A. thesis, Harvard Business School, 1974. But Graham's evidence, as is Knickerbocker's, is only on acquisition or creation of a subsidiary and does not consider its initial size or subsequent growth; and, in fact, in three cases studied by Graham, the initial entry into the foreign market was motivated (at least in large part) by "exchange of threat" considerations, but later decisions were motivated by different factors. And profits do seem to count, as Graham points out; in 1928 Colgate-Palmolive-Peet attempted to establish facilities in the United Kingdom to manufacture "Palmolive" soap as a countermove to Lever's U.S. efforts that damaged the U.S. position of Colgate-Palmolive-Peet. But "Palmolive" never was able to gain a significant market share, and this effort at "exchange of-threat" failed.

There is a limit as to how long a U.S. parent could continue to sustain losses and such losses would tend to dampen any growth in the subsidiary. Thus, the benefits of such a subsidiary to the U.S. economy are not likely to be great. Furthermore, if the parent allowed the subsidiary to reinvest the same amount of earnings as before, thereby taking all of the loss of earnings (the loss due to the increase in taxes) from the parent's shareholders; there would be a decline in U.S. GNP, of course. But also there likely would be a flow of money from the U.S. capital markets to those abroad with a resulting decline in the value of U.S. firms, see Tamir Agmon, "The Relations Among Equity Markets: A Study of Share Price Co-Movements in the United States, United Kingdom, Germany and Japan," The Journal of Finance (September 1972), p. 839.

[27] In accordance with the data in Table 3–1.

[28] See reference 13, this chapter.

RESULTS

BASE CASE

The flow of funds to and from the U.S.-owned foreign subsidiary for the base case is shown in Figure 5–1 for the current U.S. tax laws and in Figure 5–2 for a change in U.S. tax laws under which a U.S. tax is placed on the unremitted earnings of the subsidiary. The details of the calculations supporting these two figures are shown for Figure 5–1 in Table 5–1, and for Figure 5–2 in Table 5–2 under the column headed Dividend Policy, B, Year 1.

Because only a few readers are likely to study these figures and tables carefully, we have summarized the important results in Table 5–3. This table shows that if a U.S. tax is placed on the unremitted foreign earnings of U.S.

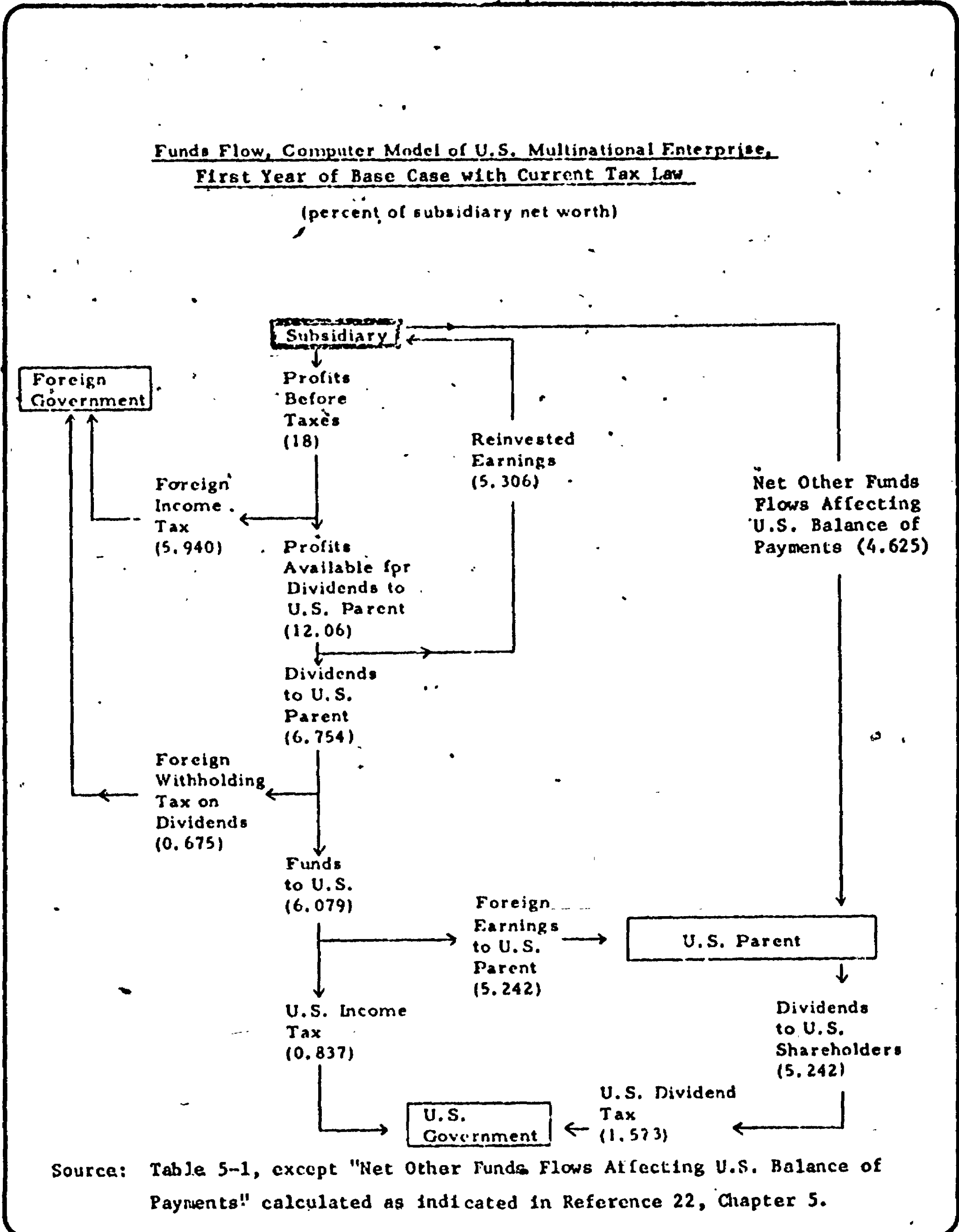


FIGURE 5–1

manufacturing operations abroad, then in the first year of the tax the net surplus of the U.S. balance of payments due to the operation of the U.S.-owned foreign subsidiary rises 16 percent, U.S. tax receipts rise 27 percent, and foreign tax receipts rise 8 percent. These increases in tax revenues reduce the profits after taxes of the U.S.-owned foreign operations by 11 percent.

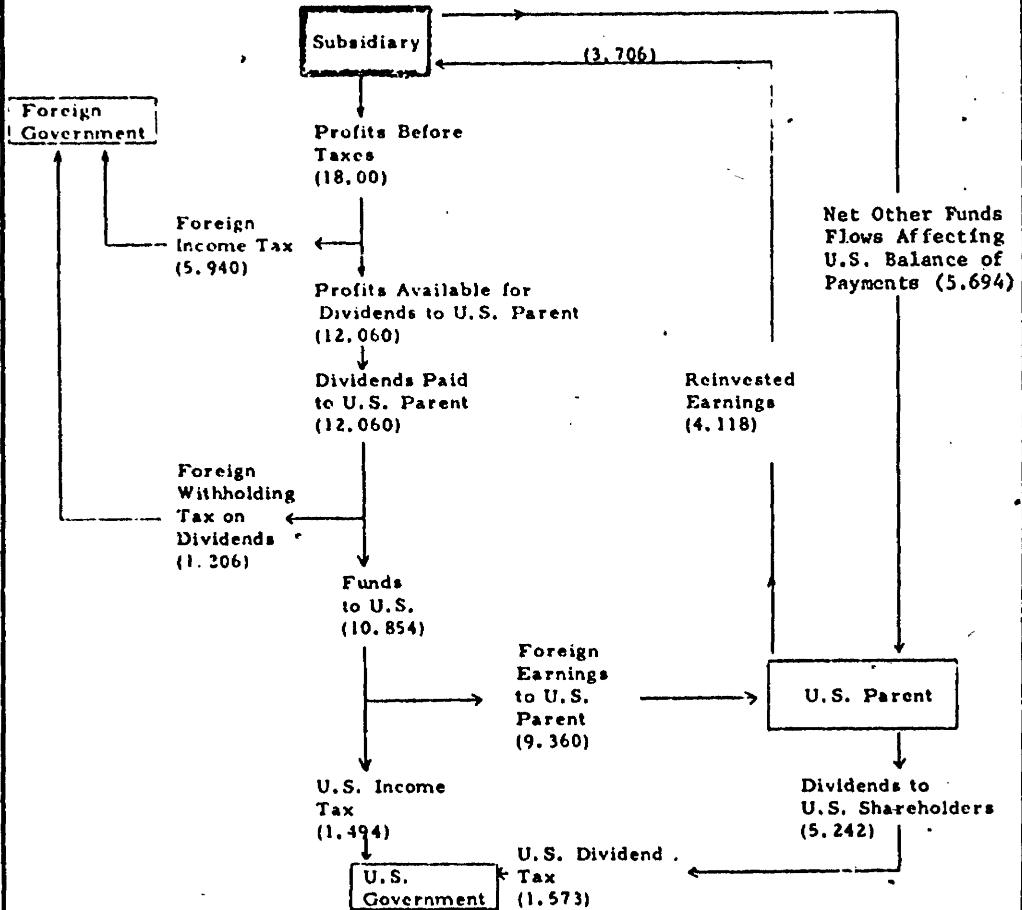
Table 5-3 also shows that the loss of earnings after taxes is taken from the reinvested earnings of the subsidiary, which are reduced by 22 percent. In contrast, during this first year, dividends to the parent's shareholders are not affected. These results come about from the assumption that with current tax laws the subsidiary reinvests 44 percent of its earnings after local taxes; but if a U.S. tax is placed on unremitted earnings, then the amount of subsidiary earnings reinvested in the subsidiary is equal to 44 percent of earnings after all taxes (both U.S. and local). However, in all subsequent years, the U.S. tax on unremitted earnings causes dividends payments to the shareholders of the parent as well as the earnings reinvested in the subsidiary to be less than if the tax did not exist. Because of the uncertainty surrounding likely reinvestment policies with a change in tax laws (as discussed above under assumptions), we have no way of knowing how close our assumptions reflect what would happen in the real world. However, the results of case 6, discussed below, suggest that the overall results of the model are not overly sensitive to different assumptions regarding reinvestment policies.

TABLE 5-1.—SAMPLE TAX CALCULATIONS, U.S.-OWNED FOREIGN SUBSIDIARY, CURRENT TAX LAWS

[Percent of subsidiary net worth at beginning of year]

Line	Item	Percent
1	Book value at start of period	100.000
2	Profits before tax	18.000
3	Foreign income tax	5.940
4	Profits after foreign income tax	12.060
5	Reinvested without return to United States	5.306
6	Dividends	6.754
7	Foreign dividend withholding tax	.675
8	Profit returned to United States after all foreign taxes	6.079
9	U.S. income tax liability	4.838
10	Total foreign tax credit	4.001
11	U.S. taxes paid on subsidiary's earnings	.837
12	Net profits available to U.S. parent after all taxes paid	5.242
13	Earnings received by parent from subsidiary and reinvested in subsidiary	0
14	Net profits available to parent after all taxes and after earnings from subsidiary reinvested in subsidiary.	5.242
15	Total subsidiary earnings reinvested in subsidiary	5.306
16	Book value at end of year	105.306
17	U.S. Taxes on dividends paid by U.S. parent	1.573
18	Total U.S. tax receipts	2.410

Sources—Line:
1 Assumed.
2 Assumed.
3 0.33×line 2.
4 Line 2−line 3.
5 0.44×line 4.
6 Calculated as follows based on assumption that 56 percent of before-tax earnings are paid as dividends:
Earnings from which dividends to be paid =0.56+18.000=10.080.
Foreign income tax on these earnings =0.33×10.080=3.326.
Profit returned to United States after foreign income tax =10.080−3.326=6.754.
7 0.1×line 6.
8 Line 6−line 7.
9 0.48×10.080 (i.e., 0.56×line 2, which represents earnings from which dividends paid).
10 Line 7+3.326 (i.e., 0.56 ×line 3, which represents taxes paid on earnings from which dividends paid).
11 Line 9−line 10.
12 Line 8−line 11.
13 Zero by definition.
14 Line 12−line 13.
15 Line 5+line 13. These reinvested earnings are accompanied by new capital outflows from the parent equivalent to 90 percent of these reinvested earnings, or 4.775 (0.9×5.306) in base case under current tax laws. These outflows are needed for the subsidiary to continue its historical growth of 10 percent yearly, see references 14 and 22, this chapter.
16 Line 1+line 15.
17 0.3×line 14.
18 Line 11+line 17.



Source: Year 1 of Policy B on Table 2, except "Net Other Funds Flows Affecting U.S. Balance of Payments" Calculated as Indicated in Reference 22, Chapter 5.

FIGURE 5-2

TABLE 5-2.—EXAMPLE THAT ILLUSTRATES ADVANTAGE OF SUBSIDIARY'S PAYING OUT ALL EARNINGS IN YEAR 1 UNDER ASSUMPTION THAT IT HAS NO EARNINGS IN YEAR 2 BUT YET REMITS FUNDS IN YEAR 2 IF U.S. TAX IS PLACED ON UNREMITTED EARNINGS

[Percent of subsidiary net worth at beginning of year]

		Dividend policy			
		(A) Pay out only earnings to be retained by parent: year—		(B) Pay out all earnings: year—	
Line	Item	1	2	1	2
1	Book value at start of period	100.000	104.118	100.000	104.118
2	Profits before tax	18.000	0	18.000	0
3	Foreign income tax	5.940	0	5.940	0
4	Profits after foreign income tax	12.060	0	12.060	0
5	Reinvested without return to United States	4.118	0	0	0
6	Dividends*	7.942	4.118	12.060	4.118
7	Foreign dividend withholding tax	.794	.412	1.206	0
8	Profit returned to United States after all foreign taxes§	7.148	3.706	10.854	4.118
9	U.S. income tax liability	8.640	0	8.640	0
10	Total foreign tax credit	6.734	.412	7.146	0
11	U.S. taxes paid on subsidiary's earnings	1.906	0	1.494	0
12	Net profits available to U.S. parent after all taxes paid	5.242	3.076	9.360	4.118
13	Earnings received by parent from subsidiary and reinvested in subsidiary.	0	0	4.118	0
14	Net profits available to parent after all taxes and after earnings from subsidiary reinvested in subsidiary.	5.242	3.706	5.242	4.118
15	Total earnings reinvested in subsidiary	4.118	−4.118	4.118	−4.118
16	Book value at end of year	104.118	100.000	104.118	100.000
17	U.S. taxes on dividends paid by U.S. parent	1.573	1.112	1.573	1.235
18	Total U.S. tax receipts	3.479	1.112	3.067	1.235

*See explanation under line 7 for year 2.
§See explanation under line 8 for year 2.

Sources for year 1—
Line No.:
Sources for year 1—Line No.:
1. Assumed.
2 Assumed.
3 0.33×line 2.
4 Line 2—line 3.
5 For policy A, 0.44×(0.52×18.000).
For policy B, zero by definition.
6 For policy A, calculated as follows: line 11+line 8—line 3.
For policy B, line 4 by definition.
7 0.1×line 6.
8 Line 6—line 7.
9 0.48×line 2.
10 Line 3+line 7.
11 Line 9—line 10.
12 Line 8—line 11.
13 For policy A, zero by definition.
For policy B, 0.44×line 12.
14 Line 12—line 13.
15 Line 5+line 13.
16 Line 1+line 15; with assumption that no additional capital from parent is invested in subsidiary.
17 .s×line 14.
18 Line 11+line 17.

Sources for year 2 same as year 1, except as follows—Line No.:
2 Assumed to be zero for purpose of this illustration.
6 Assumed for purpose of this illustration.
7 For policy A, 0.1×line 6, because this is a dividend paid out of retained earnings, Policy B, assumed to be zero because it either is a return of capital that was reinvested at end of year 1 or a return of principal on debt that was granted at end of year; in either case, it is assumed that there would be no dividend withholding tax because the payment is not a dividend.
8 The "project" returned in this case is out of retained earnings under policy A and is either capital repatriation or debt repayment under policy B.
11 Assumed that foreign tax credit is not usable to reduce U.S. taxes.
13 Assumed to be zero.

TABLE 5-3.—ESTIMATED EFFECTS OF PLACING A U.S. TAX ON UNREMITTED FOREIGN EARNINGS OF U.S.-OWNED FOREIGN SUBSIDIARY, BASE CASE, YEAR 1

[Percent of subsidiary net worth]

	Current U.S. tax laws (1)	Condition if U.S. tax placed on unremitted earnings (2)	Difference (2)−(1) (3)	Difference as a percentage of value under current U.S. tax laws 100×(3)÷(1) (4)
Effects on:				
U.S. balance of payments surplus	10.704	12.430	1.726	16
Tax revenues of U.S. Government	2.410	3.067	.657	27
Tax revenues of foreign government	6.615	7.146	.531	8
Earnings after taxes of U.S.-owned subsidiary	10.548	9.360	−1.188	−11
Earnings reinvested in subsidiary	5.306	4.118	−1.188	−22
Earnings paid out to shareholders of U.S. parent	5.242	5.242	0	0

Source: Figs. 5-1 and 5-2.

A close study of Table 5-2 illustrates why the U.S.-owned subsidiary, if its unremitted earnings are taxed, is likely to pay out all of its earnings each year and then receive a portion of these from headquarters in the form of either debt or new equity. The critical assumptions underlining this conclusion are: (1) the U.S. parent might at some time desire to have the subsidiary remit funds (other than royalties and fees or payments for exports) to the parent in a year in which the subsidiary has a loss; and (2) the host government places a tax on dividend payments but not on repayments of equity or debt. Under dividend policy A in Table 5-2, the subsidiary pays out only its portion of earnings that are to be retained by the parent (in year 1, 7.942 percent of subsidiary net worth; see line (6). On the other hand, under dividend policy B, the subsidiary pays out all of its earnings (in year 1, 12.060 percent of its net worth) and then reinvests part of them in the subsidiary (line 13). Under both policies, the parent retains the same amount of funds (5.242 percent of subsidiary net worth; see line 14) and the subsidiary reinvests the same amount of funds (4.118 percent of subsidiary net worth; see line 15). In year 2, for this illustration only and not as part of our simulation model, we assume that the subsidiary does not earn a profit, but still remits funds to the parent. Under policy A, the funds are remitted as dividends and are subjected to a withholding tax in the foreign country (.412 percent of subsidiary net worth; see line 7). In contrast, under policy B, the funds are remitted as a payment of debt or a return of capital and are not subjected to any tax in the foreign country. Under neither policy would the subsidiary be subjected to a U.S. tax in year 2, because its earnings are zero.

The net effect of the transactions is that under policy A, the parent has available less funds from the subsidiary than under policy B (in year 2, 3.706 versus 4.118 percent of subsidiary net worth; see line 14). But the subsidiary has available the same amount of funds under both policies (at end of year 2, a net worth of 100 percent of that at start of year 1; see line 16).

In order to obtain some feel for real-world effects we assumed that the U.S.-owned foreign subsidiary in our model represented all U.S.-owned foreign subsidiaries in manufacturing that would be affected if a U.S. tax is placed on unremitted foreign earnings. We do this not to obtain accurate estimates of real-world effects, but only to illustrate possible orders of magnitude. The output from the model was converted to an assumed book value of net worth of $50 billion, which roughly approximates the book value of U.S. manufacturing facilities abroad.[29]

The model shows that placing a tax on unremitted foreign earnings would, during the first year, increase U.S. tax revenues by $828 million, increase the net U.S. balance of payments by $863 million, and decrease the profits of U.S. multi-

[29] The book value was $46 billion at the end of 1973; see Survey of Current Business; August 1974, Part II, p. 72. By the end of 1975, it is likely to be $55 billion.

national enterprises by $594 million (see year 1 of table 5-4). Not shown on this table are the tax revenues of the foreign government, which rise by $266 million during year 1.

If one stopped the analysis here, one might conclude that placing a U.S. tax on the unremitted foreign earnings of U.S.-owned subsidiaries abroad would be a good policy for the United States. But such a conclusion does not reckon with the loss of competitive position of the U.S. subsidiary over time because of its lower investment rate. But this is only half of the story, for the share of the market lost by the American subsidiary is gained by the foreign competitor, whose annual growth accelerates.

TABLE 5-4.—ILLUSTRATION OF POSSIBLE ORDER-OF-MAGNITUDE EFFECTS OF PLACING A U.S. TAX ON UNREMITTED FOREIGN EARNINGS OF U.S. MANUFACTURING OPERATIONS ABROAD, BASE CASE

[Dollars in millions, assuming book value at beginning of year 1 equals $50,000 million, which approximates 1974]

Year	U.S. multinational enterprise's foreign profits after all taxes		Total U.S. tax		U.S. balance of payments	
	Current tax laws	Tax unremitted earnings	Current tax laws	Tax unremitted earnings	Current tax laws	Tax unremitted earnings
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1	$5,274	$4,680	$1,205	$1,533	$5,352	$6,215
2	5,806	5,005	1,326	1,640	5,891	6,687
3	6,391	5,295	1,460	1,735	6,485	7,174
4	7,036	5,530	1,607	1,812	7,139	7,667
5	7,745	5,682	1,769	1,862	7,859	8,152
6	8,526	5,714	1,947	1,872	8,650	8,608
7	9,385	5,576	2,144	1,827	9,523	9,012
8	10,332	5,209	2,360	1,707	10,483	9,332
9	11,373	4,539	2,553	1,487	11,540	9,524
10	12,520	3,480	2,860	1,140	12,703	9,538
11	13,782	1,941	3,148	636	13,948	9,313
12	15,172	−317	3,465	−5	15,394	
13	16,751		3,815		16,946	
14	18,385		4,199		18,654	
15	20,239		4,623		20,535	

Source: Results of computer simulations described in App. B. of report attached to statement of Robert B. Stobaugh before Committee on Ways and Means, U.S. House of Representatives, June 11, 1973.

Note: Col. (1) is years after the initiation of deferral eliminated; col. (2), (3) is profit after all foreign taxes and U.S. income tax; cols. (4), (5) is the total of U.S. income tax (48 percent) and personal dividend tax on dividends paid to shareholders (30 percent); cols. (6), (7) is the total of funds to the United States and accompanying inflows less outflows.

Of course, because of the "experience curve" effects, the unit costs of the foreign firm become lower than those of the U.S. subsidiary; hence, the foreign firm makes a greater profit than the U.S. subsidiary. These greater profits allow the foreign firm to expand even more rapidly than the U.S. subsidiary. Therefore, the difference in unit costs continue to widen because each year the foreign firm captures a larger share of the market from the U.S. subsidiary. After some years, the foreign competitor is earning a profit while the U.S. subsidiary is operating at a loss.

According to our model, by the end of the sixth year, both U.S. tax revenues and the net U.S. balance of payments position are lower with a U.S. tax on unremitted foreign earnings than with the current laws in effect. With a U.S. tax on unremitted earnings, the absolute amount of foreign profits of the U.S. enterprise reaches a peak during the sixth year and then starts to decline, becoming negative during the twelfth year. Hence, during the twelfth year, the book value of the net worth of the foreign operations begins to decline. U.S. tax revenues, following that same general pattern of company profits, also peak in the sixth year and become negative in the twelfth year. See Figure 5-3. (Although the numbers are not shown in Figure 5-3, and not summed in Table 5-4, the cumulative tax revenues during the ninth year under the current tax laws pass those with a tax or unremitted earnings.)

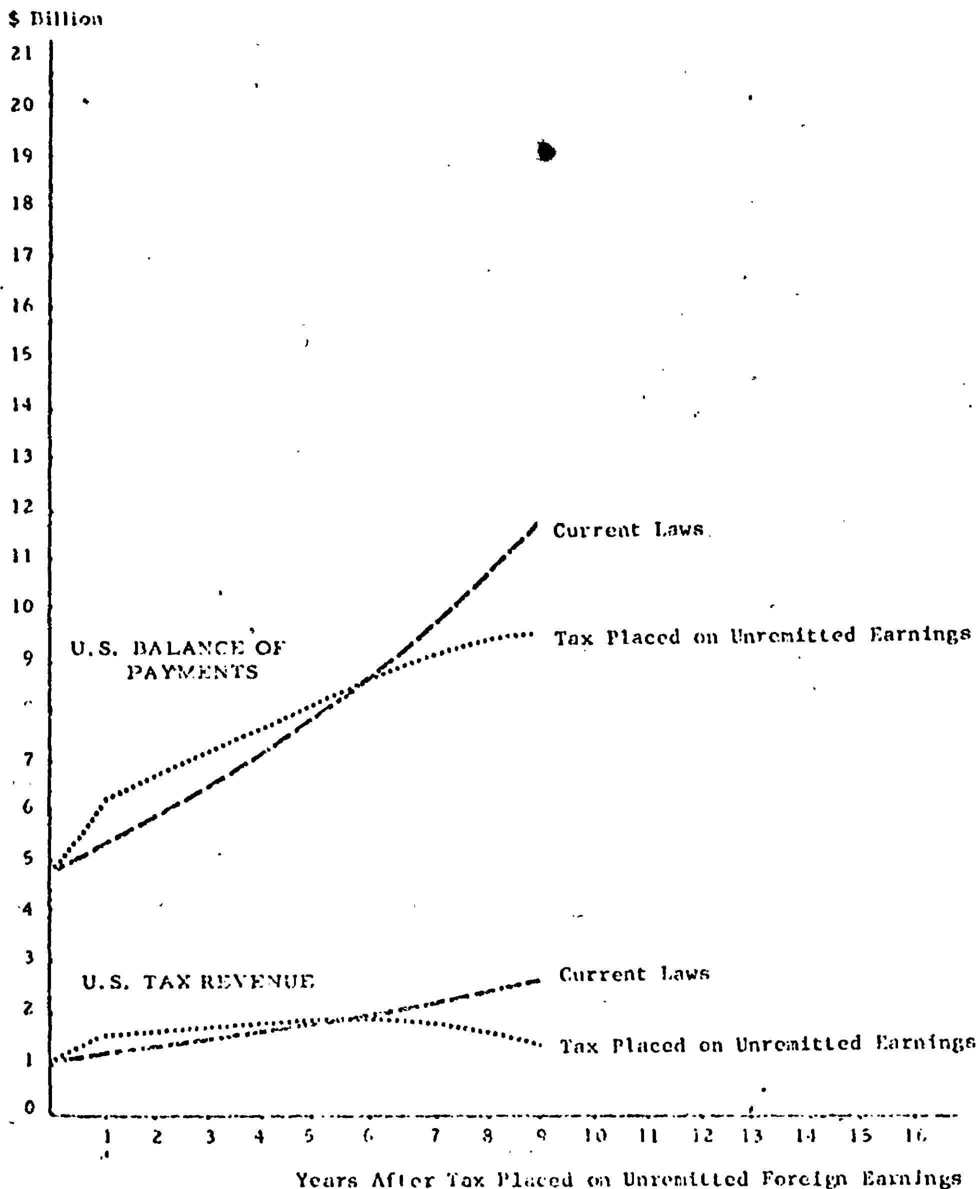


FIGURE 5-3

This model, of course, is based on the assumption that all U.S.-owned foreign operations have the same tax rate. In fact, some have a tax rate sufficiently close to that of the United States that they would be affected little by placing a tax on unremitted earnings. These operations, of course, would still be in existence for an indefinite period of time; for even after other U.S. operations were liquidated these would continue to show a profit. Thus, U.S. revenues from foreign operations probably would never drop to zero.

The net changes between the current law compared with a tax on unremitted earnings are striking by the tenth year. With a tax on unremitted earnings, corporate profits after taxes are lower by some $9 billion ($12,520 million minus $3,480 million, Table 5-4), U.S. tax revenues are lower by $1.7 billion, and the net U.S. balance of payments position is lower by $3.2 billion.

Other cases

The reader will recall that our base case assumes that the unit costs of the foreign operations are derived from a cumulative experience obtained by adding 20 percent of the parent's cumulative production to 100 percent of the cumulative production of the foreign operations. To determine the sensitivity of our conclusions to this assumption, the parent's cumulative production was given zero weight in case 2 and 100 percent weight in case 3. Of course, the subsidiary's cumulated production was given full weight in all cases.

It would be expected that the more weight given to the parent's production experience, the less adverse would be the effect on the unit costs of the foreign operations of placing a U.S. tax on unremitted foreign earnings. To illustrate: if the parent's production experience is given equal weight, then the production of the parent must be pooled with that of foreign operations in order to determine cumulative production and resulting price declines. Although with a U.S. tax on unremitted foreign earnings the foreign competitors hold a competitive advantage over the U.S.-owned operations abroad, the parents remain on equal terms and the production experience edge of the foreign competitors is diminished since subsidiaries of both the U.S. enterprise and the non-U.S. enterprise draw upon the experience of their respective parents.

As shown in Table 5-5 which presents the results of all cases, the amount of weight given the parent's production experience does not seem to have a substantial impact (this can be seen by comparing cases 2 and 3 with the base case). Lowering the weight given the parent's production experience from 0.2 to zero does not noticeably shorten the "breakeven periods"—the lengths of time needed before annual values of U.S. tax revenues and net U.S. balance of payments are higher under the current laws than with a U.S. tax on unremitted foreign earnings. They remain at six years (case 2). When full weight is given the parent's production experience, the "breakeven" period increases to eight years for both variables (case 3).

Another factor that affects the results is the rates of the income tax and dividend tax of the foreign country in which the U.S.-owned subsidiary operates. The reader will recall that the base case was simulated on the basis of the average of all foreign taxes. But because tax rates in different countries vary substantially, we simulated two other sets of tax rates in order to determine what might be the effect of tax rates in different countries encountered in the real world.

TABLE 5-5.—SUMMARY OF RESULTS, COMPUTER SIMULATION MODEL OF A U.S. MULTINATIONAL ENTERPRISE

Case	Portion[1]	Foreign income tax rate	Foreign dividend tax rate	Reinvestment rate of subsidiary earnings[2]	All earnings[3]	Dividends paid[4]	Years before annual values under current law exceed annual values with U.S. tax on unremitted foreign earnings	
							U.S. tax revenues	U.S. balance of payments
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Base	0.20	0.33	0.10	0.44	Yes	1.0	6	6
2	0	.33	.10	.44	Yes	1.0	6	6
3	1.0	.33	.10	.44	Yes	1.0	8	8
4	.20	0	.18	.44	Yes	1.0	5	5
5	.20	.28	.30	.44	Yes	1.0	0	5
6	.20	.33	.10	.75	Yes	1.0	6	11
7	.20	.33	.10	.44	No	1.0	7	7
8	.20	.33	.10	.44	Yes	.50	8	6

[1] Parent cumulated production that reduces subsidiary unit costs.
[2] Defined as proportion of subsidiary earnings after foreign income taxes under current law and as proportion of current earnings (after all taxes) reinvested by parent if unremitted earnings are subjected to U.S. tax.
[3] Paid out by subsidiary each year with subsidiary's reinvested earnings coming from parent.
[4] By U.S. parent as a portion of dividends from subsidiary retained by parent.

Note: For description of model, see app. B of report attached to statement of Robert B. Stobaugh before the Committee on Ways and Means, U.S. House of Representatives, June 11, 1973.

In case 4, we simulated the taxes that might apply in a "tax holiday" country, with zero income tax and a 10 percent tax on dividends. The simulation results indicate that "breakeven" period for both U.S. tax revenues and the U.S. balance of payments is reduced from the base case by one year (i.e. five years instead of six). The reason for this shortening of the breakeven period is that the foreign competitor has considerably more funds for reinvestment than does the U.S. subsidiary and thus lowers his costs faster than under the base case.

In case 5, we simulated a situation with a somewhat lower income tax than average but with a somewhat higher dividend tax than average; such a policy might be adopted by a country wishing to encourage the reinvestment of earnings by foreign investors. The U.S. balance of payments situation changes little from the base case (the "breakeven" period drops from six years down to five). However, the combination of a 28 percent income tax and a 33 percent dividend withholding tax results in a total foreign tax rate which approximates that of the U.S. Thus, under our assumptions, the U.S. tax rate is exceeded so U.S. taxes are no greater with a U.S. tax on unremitted earnings than under the current laws; hence, the "breakeven" period is zero.

Case 6 on Table 5–5 shows the effect of a higher reinvestment rate into the subsidiary, 75 percent versus 44 percent for the base case. The change has little or no effect on the "breakeven" period for U.S. tax revenues but increases the "breakeven" period for the U.S. balance of payments to eleven years.

Case 7 shows a change in the base case assumption that calls for the subsidiary to pay out all earnings each year. If the subsidiary only pays out those earnings that are to be retained by the parent, then the "breakeven" periods for both U.S. tax revenues and U.S. balance of payments are lengthened by only one year—to seven years.

Instead of the base case assumption that all of the funds which the parent receives from the subsidiary and retains without reinvesting in the subsidiary are paid out in the form of dividends to the parent's shareholders, we assume for case 8 that only 50 percent of such earnings were paid out. This lengthened the "breakeven" period for U.S. tax revenues to eight years, but, of course, did not affect the U.S. balance of payments.

Summary

A perusal of Table 5–5 shows that in 15 of the 16 observations, the length of time needed before annual values of U.S. tax revenues and net U.S. balance of payments are higher under current tax laws than with a U.S. tax on unremitted foreign earnings is eight years or less. And 14 of the 16 show a period of five to eight years. In fact, the results seem to be quite insensitive to wide ranges of assumptions.

None of the foregoing considers the potential impact on the income level in the United States, Although—at least in theory—fiscal and monetary policy can be used to offset any job losses that result from a slower growth of U.S. subsidiaries abroad, the resulting income level with a change in tax law is likely to be lower. This in turn would reduce tax payments to the U.S. Treasury. This could involve substantial tax revenues. For example, if we assume the following three conditions:

(1) that our estimate of 700,000 jobs associated with U.S. foreign direct investment is correct;

(2) that half of these would be affected over a period of years by the reduced U.S. foreign direct investment activity resulting from a U.S. tax on unremitted foreign earnings; and

(3) that the earnings of these 350,000 affected workers would be reduced by the $4,000 yearly which we estimated in Chapter 1 exists between employees in the nine U.S. manufacturing industries which are the major foreign direct investors and other U.S. manufacturing industries;

then the reduction in income would be $1.4 billion. If these earnings are taxed at an incremental rate of 30 percent, the loss to the U.S. Treasury would be $420 million.

Chapter 6

A BETTER APPROACH

A substantial body of evidence presented in Chapter 1 indicates that U.S. foreign direct investment helps the U.S. economy, by increasing per capita income, number of jobs, and balance of payments surplus. Because there is a good case for considering investment abroad as primarily an export of services rather than an investment,[1] such exports of services should be protected just as exports in goods are. However, we do not favor blanket support of all the actions of U.S. multinational enterprises. Instead, we favor adopting legislation to solve certain problems rather than adopting legislation that, on the one hand, would give complete freedom to multinational enterprises or, on the other hand, would seriously hinder or stop their growth. In some cases this may mean legislation that corrects undesirable practices at home, such as the firing of older workers without adequate retraining or pension benefits. But in other cases, such as changing the rules on the taxation of foreign income, it may mean that U.S. actions should be coordinated with parallel actions by other industrialized countries that also provide a headquarters for multinational enterprises. Otherwise there is a risk that by handicapping U.S.-based enterprises in their operations abroad we may be damaging the very interests that are the object of the regulatory measures, namely, the interests of the U.S. economy.

Take the job issue, for example. To be sure, same multinational enterprises have laid off workers with many years of experience and nearing retirement age, thereby causing a reduction of retirement benefits.[2] However, a solution to the unemployment problem should consider technological change and have a far broader focus than only the unemployment associated with international investment and trade. A study by the Bureau of Labor Statistics indicates that about ten times as many jobs are "lost" to the U.S. economy because of increased productivity as are "lost" from imports,[3] and six times as many jobs are "lost" because of increased productivity as the AFL-CIO claims have been "lost" by foreign direct investment. There is considerable overlap in these two counts of job displacement (from imports and foreign direct investment) because increased imports represent part of the adjustment in our economy to the increased exports caused by U.S. foreign direct investment.

Although U.S. unions have devoted some of their bargaining to a guaranteed annual wage or a portable pension, both of which are worthy objectives, we believe that far broader goals are justified. In fact, the results of the Japanese system, in which most industrial workers are virtually guaranteed a job for all of their working life, might be desirable. Unfortunately, so little reseahch has been done in this area that we barely know the definition of the problems, much less than answers. This is an area that should receive considerable research support by the Department of Labor.

In addition to number of jobs, there is another issue related to employment—concern about the income distribution effects within the United States of U.S. foreign direct investment. However, U.S. policy should not attempt to reduce any extra profit earned by U.S. enterprises in using their technology, marketing knowledge, and other tangible and intangible assets as a package rather

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[1] See Robert B. Stobaugh, "The Hidden Plusses of Multinationals," "Wall Street Journal," June 6, 1973, p. 20; for a longer version, see Robert B. Stobaugh. 'A Proposal to Facilitate International Trade in Management and Technology," Working Paper 73-29, New York University, June 1973.

[2] The current "adjustment assistance" given to U.S. workers is very narrow in scope. This assistance could be expanded to include benefits to U.S. workers displaced by any reduction in U.S. exports caused by a start-up of foreign production facilities, whether or not thees foreign facilities export to the United States. For example, if a U.S.-owned factory in Brazil begins exporting to France thereby reducing U.S. exports to France, some U.S. workers might lose their jobs. Adjustment assistance should be given to these workers (a suggestion that Raymond Vernon made to me).

[3] William Shelton, "The Relationship Between Changes in Imports and Employment in Manufacturing in the United States, 1960-65" (Mimeograph), Paper Presented to Annual Meeting of American Statistical Association, 1970. For example of layoffs, see Irwin Ross, "Labor's Big Push for Protectionism," Fortune (March 1973), p. 92.

than selling each separately.[4] For as pointed in Chapter 1, the optimal way to attain any income distribution goal is never one that reduces total income available for redistribution. Rather U.S. policy should concentrate on maximizing the nation's income and then redistributing it in the desired pattern.

As for income taxes, the income reported by multinational enterprise in each of the various countries in which they operate sometimes contains an inherent arbitrariness because of the impossibility of placing a true "arm's length" price on transactions among members of a multinational enterprise. Therefore, there is a case to be made for totaling the worldwide income of such an enterprise and allocating it for tax purposes among nations in which the enterprise operates. Such an approach would take time to institute and would necessitate an international tax agreement, but would have the advantage of ensuring that U.S. multinational enterprises do not labor under more difficult tax loads than their principal foreign competitors—multinational enterprises of other countries.[5]

This study has considered only the effects of taxing unremitted earnings. Of course, some intermediate steps such as taxing unremitted earnings on selected types of income have been discussed, and indeed have been proposed.[6] We have not estimated the effects of any of these multitude of possible intermediate steps, but the directions of the effects would be similar to those described in this study—an initial small gain to the U.S. economy followed by substantial losses over the long run. We hope that our simulation model will be useful for any future studies of such intermediate steps.[7]

Furthermore, changes in the tax laws might systematically discriminate against one group of companies that Congress probably would have no wish to damage. Requiring a minimum payout of foreign earnings would be especially hard on smaller firms that are relatively new overseas, for these enterprises are depending upon the reinvestment of foreign earnings to fuel their foreign growth. The more experienced firms, typically large, already withdraw substantial amounts of funds from overseas.[8]

In the meantime, the stakes are so large that we should be careful about upsetting the current competitive situation. Foreign markets, which in the aggregate are larger than our own, cannot be served by U.S. firms by exports alone. Taxation that slows down or cuts off U.S. foreign direct investment would reduce our participation in these foreign markets and reduce the flow of funds received from U.S. operations abroad. The result might well be either the imposition of restrictions to reduce imports or a devaluation of the dollar. The ultimate result of this cycle most likely would be a lower per capita income in the United States than if current tax laws remained as is.

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[4] It has usually been assumed that U.S. firms could earn more profits by using these assets as a package rather than selling the elements separately, because these are obvious efficiencies in operating a worldwide network of facilities in a coordinated way rather than having each facility operate separately. However, in theory it is possible for a U.S. firm to charge a sufficiently high price for its know-how so that its total earnings would be higher than if it invested abroad. It could be further hypothesized that the reason more licensing is not done is because managers have a bias towards investing abroad rather than licensing, because it is better for their careers to control a large network of facilities (an hypothesis given to me by Raymond Vernon). There has been no test of this hypothesis, but Piero Telesio is now studying the subject for his doctoral thesis at Harvard Business School.

[5] As Gary C. Hufbauer pointed out to me, this is a lot easier said than done. A variety of bases could be used in allocating profits; for example, assets, payroll, and sales. And depending upon the formula, the allocation of a factory's profits might be changed if, for example, it replaced workers with a machine. Obviously a change in allocations would make the officials of one government happy and the officials of another unhappy, depending upon which government gained revenues and which lost. Even after 30 years of experience in the United States, the individual states often do not agree on the allocation of a corporation's profits.

[6] See Department of the Treasury, Proposals for Tax Change, Apr. 30, 1973.

[7] For a description of the model, see Appendix B of report attached to statement of Robert B. Stobaugh before the Committee on Ways and Means, U.S. House of Representatives, June 11, 1973.

[8] Sidney M. Robbins and Robert B. Stobaugh, Money in the Multinational Enterprise (New York: Basic Books, 1973), Chapter 5.

TABLE A-1.—NAME, NATIONALITY, AND SALES OF 10 FIRMS WITH LARGEST SALES IN 1971 IN 9 INDUSTRIES WORLDWIDE INCLUDING UNITED STATES

[Sales in billions of U.S. dollars]

PRIMARY AND FABRICATED METALS [1]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
2	1	Nippon Steel	Japan	$4.09	$7.63
1	2	United States Steel	United States	4.93	6.95
3	3	British Steel	United Kingdom	3.22	4.29
5	4	August Thyssen Hutte	Germany	2.90	4.24
4	5	Bethlehem Steel	United States	2.96	4.14
6	6	Pechiney	France	2.46	3.61
7	7	Nippon-Kokan	Japan	2.12	3.61
9	8	Gutehoffnung-Shutte	Germany	1.96	2.93
10	9	Krupp-Konzern	do	1.84	2.91
8	10	BHP	Australia	2.10	1.30

FOOD PRODUCTS [2]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	Unilever	United Kingdom-Netherlands	$7.48	$11.00
2	2	Nestle	Switzerland	3.54	5.21
3	3	ESMARK [3]	United States	3.00	3.95
5	4	British-Am. Tobacco	United Kingdom	2.26	3.74
4	5	Kraftco	United States	2.96	3.60
7	6	Armour	do	2.26	[4] 3.00
9	7	Beatrice	do	1.83	2.79
6	8	General foods	do	2.28	2.63
8	9	Borden	do	2.07	2.55
10	10	Associated British Foods	United Kingdom	1.52	2.08

NONELECTRIC MACHINERY [5]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	International Harvester	United States	$3.02	$4.20
2	2	Caterpillar	do	2.17	3.18
4	3	John Deere	do	1.19	2.00
3	4	American Standard	do	1.41	1.53
5	5	Massey-Fergusson	Canada	1.03	1.51
6	6	SKF	Sweden	.95	1.35
7	7	Allis Chambers	United States	.85	1.16
8	8	Ingersoll-Rand	do	.80	1.04
10	9	Komatsu	Japan	.69	1.01
9	10	Otis Elevator	United States	.79	1.00

PAPER [6]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
9	1	Bowater	United Kingdom	$0.62	$2.45
1	2	International Paper	United States	1.97	2.31
3	3	Crown Zellerbach	do	.99	1.37
2	4	Mead Corp	do	1.06	1.30
7	5	MacMillan Bloedel	Canada	.74	1.21
4	6	Kimberly Clark	United States	.94	1.18
5	7	St. Regis	do	.91	1.13
6	8	Scott Paper	do	.75	.91
8	9	Feldmuhle-Dynamit Nobel	Germany	.66	[7] .80
10	10	Domtar	Canada	.51	.66

RUBBER [8]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	Goodyear	United States	$3.60	$4.68
3	2	Dunlop/Pirelli	United Kingdom-Italy	2.36	3.27
2	3	Firestone	United States	2.48	3.15
5	4	Michelin	France	1.50	2.20
4	5	Uniroyal	United States	1.68	2.08
6	6	Goodrich	do	1.30	1.72
7	7	General	do	.99	1.38
8	8	Bridgestone	Japan	.51	.98
9	9	Continental	Germany	.43	.65
10	10	Dunlop-Australia	Australia	.38	.52

CHEMICALS [9]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
4	1	BASF	Germany	$3.21	$5.39
2	2	ICI	United Kingdom	3.72	5.31
1	3	DuPont	United States	3.85	5.28
6	4	Bayer	Germany	2.65	4.65
3	5	Montedison	Italy	3.27	4.45
5	6	Union Carbide	United States	3.03	3.94
7	7	Akzos	Netherlands	2.31	3.38
8	8	Rhone Poulenc	France	2.18	3.30
10	9	Dow	United States	2.05	3.07
9	10	Monsanto	do	2.09	2.65

PHARMACEUTICALS [10]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	Ciba Geigy	Switzerland	$1.84	$2.54
2	2	American Home Products	United States	1.43	1.78
4	3	Warner Lambert	do	1.35	1.67
8	4	Kanebo	Japan	.78	1.53
3	5	Hoffman-LaRoche	Switzerland	1.40	1.46
5	6	Pfizer	United States	.95	1.28
9	7	Sandoz	Switzerland	.73	1.15
7	8	Merck	United States	.83	1.12
10	9	Eli Lilly	do	.72	.97
6	10	Squibb	do	.83	.88

AUTOMOTIVE [11]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	General Motors	United States	$28.26	$35.80
2	2	Ford	do	16.43	23.02
3	3	Chrysler	do	8.00	11.77
4	4	VW	Germany	4.97	6.42
5	5	Daimler-Benz	do	3.46	5.55
6	6	Toyota	Japan	3.31	5.55
7	7	Mitsubishi	do	3.13	5.23
8	8	Nissan	do	3.13	4.88
9	9	Fiat	Italy	2.94	4.07
10	10	British-Leyland	United Kingdom	2.84	3.83

ELECTRONIC MACHINERY [12]

Rank 1971	Rank 1973	Firm	Headquarters nation	Sales 1971	Sales 1973
1	1	General Electric	United States	$9.42	$11.58
2	2	IBM	do	8.27	10.99
4	3	Philips	Netherlands	5.19	8.19
3	4	Western Electric	United States	6.04	7.04
7	5	Hitachi	Japan	3.63	5.97
5	6	Siemens	Germany	3.81	5.52
9	7	Matsushita	Japan	2.69	4.41
6	8	RCA	United States	3.71	4.25
8	9	AEG-Telefunken	Germany	2.69	4.19
10	10	Tokyo-Shibaura	Japan	2.55	4.02

[1] Change in total sales from 1971 to 1973: U.S. firms, 41 percent, non-U.S. firms, 47 percent.
[2] Change in total sales from 1971 to 1973: U.S. firms, 25 percent, non-U.S. firms, 50 percent.
[3] Formerly Swift.
[4] Not available from "Fortune 500"; estimated by authors based on growth of Esmark from 1971 to 1973.
[5] Change in total sales from 1971 to 1973: U.S. firms, 39 percent, non-U.S. firms, 40 percent.
[6] Change in total sales from 1971 to 1973: U.S. firms, 40 percent, non-U.S. firms, 243 percent.
[7] Not available from "Fortune 500"; estimated by authors based on growth of other firms in industry.
[8] Change in total sales from 1971 to 1973: U.S. firms, 28 percent, non-U.S. firms, 46 percent.
[9] Change in total sales from 1971 to 1973: U.S. firms, 32 percent, non-U.S. firms, 52 percent.
[10] Change in total sales from 1971 to 1973: U.S. firms, 25 percent, non-U.S. firms, 41 percent.
[11] Change in total sales from 1971 to 1973: U.S. firms, 34 percent, non-U.S. firms, 70 percent.
[12] Change in total sales from 1971 to 1973: U.S. firms, 43 percent, non-U.S. firms, 57 percent.

Source: "Fortune," the Fortune Directory of the 500 Largest Industrial Corporations, May 1972 and 1974; the Fortune Directory of the 300 Largest Industrials Outside the United States, August 1972 and 1974.

TABLE A-2.—SALES AND NUMBER OF AFFILIATES, FOREIGN MANUFACTURING OPERATIONS, UNITED STATES AND NON-UNITED STATES MULTINATIONAL ENTERPRISES, 1970

Geographic location of affiliates	Sales of foreign affiliates (millions)		Number of affiliates		Average sales per affiliate (millions)	
	U.S. parents	Non-U.S. parents	U.S. parents	Non-U.S. parents	U.S. parents	Non-U.S parents
United States		$14,800		400		$37
Canada	$11,600	4,900	620	270	$19	18
Other Western Hemisphere	8,900	8,100	1,370	640	6	13
Europe	36,400	36,300	2,180	2,290	17	16
Rest of world	8,400	18,400	1,320	2,040	6	9
Total	65,300	82,500	5,490	5,640		
Average					12	[1] 13, [2] 15

[1] Excluding sales in United States.
[2] Including sales in United States.

NOTES

Number of parent systems equals 187 for U.S. parents; 209 for non-U.S. parents. Average foreign sales of each system equals $349,000,000 for U.S. parents; $395,000,000 for non-U.S. parents, including sales in United States; $324,000,000 for non-U.S. parents, excluding sales in United States.

Because comparable data are not available, it was inevitable that the criteria used in this table to define a U.S. firm as a multinational enterprise differed somewhat from that used to define a non-U.S. firm as a multinational enterprise. The best source of non-U.S. data is in reference 1, below, so this same source was used for the sample of U.S. firms, although this one source used slightly different criteria. But the criteria are sufficiently similar so as not to invalidate the conclusions drawn from this table. The use of similar criteria would have resulted in about the same number of parents (see reference 2, below, for support for this statement). Thus, if the criteria used to select U.S. firms had been used to select non-U.S. firms, then 180 or so non-U.S. firms would have been selected. The 29 or so non-U.S. firms that would have been dropped from the sample compared with those remaining in the sample are smaller by definition in terms of number of foreign manufacturing affiliates, and likely are smaller in terms of total sales of foreign manufacturing affiliates and average sales per foreign manufacturing affiliate. Thus, although the use of similar criteria would lower the total sales of foreign manufacturing affiliates of non-U.S. parents, it is unlikely that the total would drop to the level of the foreign affiliates of U.S. parents; the use of similar criteria also would lower the number of affiliates perhaps to about the U.S. level—and increase the average sales per foreign manufacturing affiliate. In the current sample, this latter measure is higher for non-U.S. firms than for their U.S. counterparts, so an important conclusion emerges—in a comparable sample, the gap between the average size of the non-U.S. affiliate and U.S. affiliate would be even larger. There are 2 other sources of evidence which suggest that the above table is biased towards making the foreign operations of non-U.S. firms appear to exceed those of U.S. firms by a lesser amount than they actually do. (1) For non-U.S. parents, the sales of foreign manufacturing affiliates and number of affiliates per parent likely is biased toward the low side because of incomplete coverage of the survey (Source: Interview with authors of reference 1, below). (2) The estimate of the total sales of foreign manufacturing affiliates of the 187 U.S.-based multinational enterprises likely is biased upward (see discussion below under sources: Sales of foreign affiliates of U.S. parents). The net result is that the use of comparable samples and perfect data would be very unlikely to change the basic conclusions drawn from the above table.

SOURCES

Sales of foreign affiliates of U.S. parents—Sales of manufacturing affiliates of parents in all industries plus those affiliates of petroleum-industry parents that produce refined oil products and which are categorized as refining and processing affiliates and the pro-rata share of such affiliates from the output of integrated petroleum operations. These were obtained for 1966 affiliates that were majority-owned by U.S. firms from reference 4 below. These 1966 totals for majority-owned affiliates were expanded to include other affiliates by multiplying by 1.088 (source: reference 5). The totals for the world were multiplied by 0.72 and the totals for the "world minus Canada" were multiplied by 0.82 to obtain an estimate of the sales of the 187 U.S.-owned multinational enterprises (source: reference 6); sales for Canada then were calculated by difference (there is some evidence that the 0.72 factor, and thus the resulting totals for the world, might be biased upward, see reference 7). Finally, these estimates were converted to a 1970 basis by assuming the same growth as reported for the foreign affiliates of the 223 U.S.-owned multinational enterprises with manufacturing-industry parents for which the U.S. Department of Commerce collected statistics for 1966 and 1970 (source: reference 8). Rounded to nearest 100.

Sales of foreign affiliates of non-U.S. parents—calculated from data in reference 9. Rounded to nearest 100.

Number of affiliates of U.S. parents—calculated from data in reference 10 for 1967 and up-dated for 1970 by assuming same growth rate in each geographic area as was experienced from 1959 to 1967 (these growth rates calculated from reference 11). Rounded to nearest 10.

Number of affiliates of non-U.S. parents—calculated from data in reference 10 below. Rounded to nearest 10.

Sales per affiliate—calculated by dividing "sales of foreign affiliates" by "number of affiliates."

REFERENCES

1. James W. Vaupel and Joan P. Curhan, "The World's Multinational Enterprises" (Boston: Division of Research Graduate School of Business Administration, Harvard University, 1973), pp. 2-3.
2. Reference 1, p. 3.
3. U.S. Department of Commerce, "U.S. Direct Investments Abroad, 1966, Pt. II: Investment Position, Financial and Operating Data" (Springfield, Va.: National Technical Information Service, 1971 and 1972).
4. Reference 3, "Group 1, Preliminary Report on Foreign Affiliates of the U.S. Petroleum Industry," p. 75; "Group 2 Preliminary Report on Foreign Affiliates of U.S. Manufacturing Industries, pp. 70–76; and "Group 3, Preliminary Report on Foreign Affiliates of U.S. Reporters in U.S. Industries Other than Manufacturing and Petroleum, pp. 50–54.
5. Reference 3, "All Industries—Summary, Preliminary Results for Pt. II, All Industry Groups," pp. 105, 108.
6. Reference 1, p. 4.
7. U.S. Department of Commerce, "Special Survey of U.S. Multinational Enterprises, 1970" (Springfield, Va.: National Technical Information Service, 1972), p. 3.
8. Reference 7, pp. 22–23, 26–29, 42–43.
9. Reference 1, pp. 40–47.
10. Reference 1, pp. 32–39.
11. Raymond Vernon, "Sovereignty at Bay" (New York: Basic Books, 1971), p. 62.

A CRITIQUE OF PROFESSOR PEGGY B. MUSGRAVE'S STUDY, "DIRECT INVESTMENT ABROAD AND THE MULTINATIONALS: EFFECTS ON THE U.S. ECONOMY" [a] BY ROBERT B. STOBAUGH, PROFESSOR, HARVARD BUSINESS SCHOOL,[b] MARCH 1976

Professor Musgrave's study attempts to analyze the long-term impact of U.S. foreign direct investment on the basic structure of the U.S. domestic economy. She focuses particularly on the distribution of economic returns between capital and labor that results from such foreign investment. Her primary analysis is based on a comparison of the U.S. economy in 1968 with what she estimates the U.S. economy would have been "if the capital accumulated abroad as of 1968 had been invested domestically." [1]

Professor Musgrave's principal conclusion is that U.S. foreign direct investment has caused U.S. labor income to be less than it would otherwise have been and U.S. capital income to be greater than it otherwise would have been. She calculates several sets of results, each based on somewhat different assumptions. The set to which she most frequently refers, and which I have dubbed the "base case," shows a decline of about 4 percent in U.S. labor income and a rise of 17 percent in U.S. capital income. She concludes that U.S. national income and U.S. tax revenues have been changed very little—her base case shows a decline of less than 1 percent for each of these factors.[2]

Professor Musgrave's study, of course, is a carefully documented, scholarly report. She spells out the numerous assumptions needed to arrive at her estimates, and, indeed, makes a number of qualifying statements. But it is possible that U.S. policymakers might overlook such details, and, of course, the press cannot fully report them. Yet an understanding of such assumptions is of crucial importance in arriving at a judgment as to whether her study is useful for policymaking purposes.

I conclude that her study is not sufficiently realistic for policymaging purposes because (1) the economic model on which she bases her analysis is too simple to reflect the important real-world effects of U.S. foreign direct investment; and (2) a number of her assumptions are unrealistic. In addition to reviewing these factors, I will also indicate some of the negative economic effects that likely would result from the adoption of the policy that Professor Musgrave's study seems to imply—the placing of higher U.S. taxes on U.S. foreign direct investors in manufacturing.

1. SIMPLISTIC ECONOMIC MODEL

Professor Musgrave's economic model is one in which national income and the distribution of this income between labor and capital is determined by an equation with two independent homogeneous variables—capital and labor.[3] She defines capital as the physical stock of goods; in her base care, this is taken to be structures, equipment, and inventories,[4] She defines labor as "number of man-hours worked." [5]

These definitions are inadequate because they do not indicate the share of national income generated by the increase in the knowledge and skills of the U.S. workforce. Yet, much of the growth in the U.S. national income has been a result of increases in knowledge and skills rather than just increases in the physical stock of capital and man-hours of labor.[6] Economists, of course, recognize that the economic output of a skilled worker is not identical to that of an unskilled

[a] Prepared by Professor Peggy B. Musgrave of Northeastern University, August 1975, at the request of the Subcommittee on Multinational Corporations (the so-called "Church Subcommittee") of the Committee on Foreign Relations, United States Senate.

[b] This critique was prepared by me for the Management Analysis Center, Inc. (MAC), of Cambridge, Mass. This MAC activity is being funded by Eli Lilly and Company; Merck & Co., Inc.; Pfizer Inc.; Schering-Plough Corporation; G. D. Searle & Co.; Smith Kline Corporation; and Squibb Corporation. However, this critique represents my views and not necessarily those of any other person or organization.

[1] Peggy B. Musgrave, "Direct Investment Abroad and the Multinationals: Effects on the United States Economy" (Washington, D.C.: U.S. Government Printing Office, 1975), p. IX. I henceforth refer to this study as the "Musgrave Study."

[2] These results also are the ones quoted in the *New York Times*, Feb. 23, 1976, pp. 37–38. She calculates two other cases, which I mention later. She also reports on "income originating in the United States," which she indicates declines about 3 percent in her base case. Musgrave Study, p. XVII.

[3] Musgrave Study, pp. 48, 100.

[4] *Ibid.*, pp. XVII, 103.

[5] *Ibid.*, p. 48.

[6] For example, see R. M. Solow, "Technical Change and the Aggregate Production Function," *Review of Economics and Statistics* (May 1957), pp. 312–20; Edward F. Denison, "Accounting for U.S. Economic Growth 1929–1969." (Washington, D.C.: The Brookings Institution, 1974); and "The Silent Crisis in R&D," *Business Week*, Mar. 8, 1976, pp. 90–92.

worker. In the words of Paul A. Samuelson, "There is no single factor of production called labor; there are thousands of quite different kinds of labor." [7]

The failure to take into account the creation of job skills and knowledge and their contribution to national income and income distribution causes Professor Musgrave to understate the benefits that the U.S. economy derives from the U.S. multinationals. Their activities create U.S. jobs requiring higher skills than the average of all U.S. manufacturing.[8] Furthermore, they create proportionately more knowledge than other U.S. manufacturing firms. The 187 companies classified as multinational enterprises by the Harvard Business School Multinational Enterprise Project account for one-third of the total domestic sales of U.S. manufacturing firms but do two-thirds of the privately funded industrial research and development performed in the United States.[9] And part of this R&D is a result of foreign direct investment by U.S. multinationals—foreign activities result in a larger market over which to use the knowledge.[10] Furthermore, the U.S. parent receives knowledge from its foreign operations.

Because higher skills and more knowledge result in a higher paid workforce, it is not surprising to find that U.S. foreign direct investors pay higher wages and salaries than other U.S. manufacturing companies; [11] yet evidence indicates that they are not systematically more capital-intensive than other U.S. manufacturing companies.[12]

2. UNREALISTIC CRUCIAL ASSUMPTIONS

a. Full employment

Professor Musgrave assumes that there is full employment in the United States, and, in fact, chose 1968 as the year for the study "because it was a full-employment year." [13] She not only assumes this for labor but also for capital. That the full-employment assumption is unrealistic for current conditions needs no further discussion given the current level of unemployment in the United States and the underutilization of plant and equipment.[14]

b. Perfect competition

She assumes that the markets for both labor and capital come "close to behaving as if in perfect competition." [15]

Thus, even if Professor Musgrave's model incorporated various levels of labor skills, which it does not, then perfect competition would only result if the price of each type of labor were determined in a marketplace in which innumerable firms requiring this type of labor were bidding for the services of innumerable workers of this type. This obviously does not describe the U.S. economic system.[16]

Similarly, her assumption that the market for all capital is perfectly compet-

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[7] Paul A. Samuelson, *Economics* (New York: McGraw Hill, 1967), p. 551.

[8] For some empirical findings, see Robert B. Stobaugh, Piero Telesio and Jose de la Torre, "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment, and Changes in Skill Composition of Employment," *Occasional Paper No. 4* of Center for Multinational Studies, Washington, D.C., February 1973.

[9] Raymond Vernon, *Sovereignty at Bay* (New York: Basic Books, 1971), Chapter 3, and National Science Foundation, *Research and Development in Industry* (Washington, D.C.), various issues such as 1970.

[10] I am not aware of any study showing the amount of U.S. R&D resulting from U.S. foreign direct investment. In 1972, U.S. companies received from abroad over $8 billion in royalties and management fees. The bulk of these receipts were by U.S. foreign direct investors ostensibly in exchange for knowledge, but this sum should not be considered as being an accurate measure of the market value of such knowledge; see Robert B. Stobaugh, "Summary and Assessment of Research Findings on U.S. International Transactions Involving Technology Transfers," in Rolf R. Piekarz (ed.), *The Effects of International Technology Transfers on U.S. Economy* (Washington, D.C.: Superintendent of Documents, U.S. Government Printing Office, July 1974), pp. 15–16. Recent research reveals the propensity of U.S. multinationals to conduct R&D in the United States; see Robert C. Ronstadt, "R&D Abroad: The Creation and Evolution of Foreign Research and Development Activities of U.S.-Based Multinational Enterprises," unpublished D.B.A. thesis, Harvard Business School, 1975.

[11] U.S. Tariff Commission, *The Multinational Corporation and the World Economy* (Washington, D.C.: U.S. Government Printing Office, 1973), p. 732.

[12] William H. Gruber, Dileep Mehta, and Raymond Vernon, "The R&D Factor in International Trade and International Investment of United States Industries," *Journal of Political Economy*, February 1967, pp. 20–37.

[13] Musgrave Study, pp. XIV, 100, and 103.

[14] At the end of 1975, capacity utilization in the United States was less than 75 percent, "Economic Report," Manufacturers Hanover Trust, February 1976.

[15] Musgrave Study, p. 100.

[16] Paul A. Samuelson, Economics, Chapter 29.

itive is unrealistic. Investors obviously are not aware of all investment opportunities and so do not always invest at the highest rates of profit. Indeed, Professor Musgrave recognizes one imperfection—the preference of firms for internal finance and for reinvestment in their own branch of industry.[17]

c. Displacement of domestic investment

Even if she had not made these two unrealistic assumptions, the results of her model would still depend heavily on her assumption that if no U.S. firm had invested abroad, domestic investment would have increased by an amount equal to the value of all U.S. foreign direct investment accumulated abroad—about $80 billion through 1968.[18] This includes all retained earnings as well as net capital outflows through the entire history of U.S. foreign direct investment. She, of course, recognizes that the outcome of her analysis depends "heavily on whether or not U.S. investment abroad does or does not mean less investment at home."[19]

Her assumption that foreign investment displaces domestic investment is, indeed, an assumption and is not based on empirical evidence. The importance of this assumption is shown by the results of a second case calculated by her and a third case on which she provided information but did not explicitly present the results. In her second case, she assumes that 48 percent, rather than 100 percent, of U.S. foreign direct investment substitutes for U.S. domestic investment; for this case she found that the net result of foreign investment was a slight increase in U.S. national income, with a small decline (2 percent) in labor income more than offset by an increase in capital income (about 17 percent). As a footnote to a table she provided numbers for a third case in which U.S. foreign direct investment does not substitute at all for U.S. domestic investment. This third case indicates that the net effect of U.S. foreign direct investment is to increase U.S. national income, with no decrease in labor income and an increase in capital income. But she did not discuss the results of this case because she believed that the case was "too restrictive."[20]

Yet, assumptions in this last case are consistent with the conclusions of a massive study by the U.S. Tariff Commission. "One can safely assume a zero net effect on domestic investment when the foreign investment takes place,"[21] the Commission said. The reason: U.S. monetary policy far overshadows the amount of funds involved in U.S. foreign direct investment. Professor Musgrave, of course, recognizes this possibility, for she states that even if foreign investment is a substitute for domestic investment, stabilization policy can be used to offset reduced domestic investment—"the final outcome will depend on the conduct of stabilization policy."[22] But then she concludes that the "presumption remain that there will be a substantial amount of displacement of domestic investment,"[23] though she does not present evidence to support such a strong statement.

The Tariff Commission's conclusion that domestic investment is unaffected by foreign investment is consistent with those econometric studies which conclude that demand for goods rather than supply of funds is a major determinant of investment within the United States.[24] And a recent study concluded that U.S. investment by U.S. firms and foreign investment by U.S. firms seemed to be complements for one another rather than substitutes. During years in which plant and equipment expenditures by U.S. firms abroad were relatively high, U.S. domestic plant and equipment expenditures were also relatively high.[25]

Furthermore, these studies are consistent with my studies indicating that a relatively small percentage of U.S.-owned output abroad substitutes for U.S.

[17] Musgrave Study, p. 40.
[18] *Ibid.*, p. IX.
[19] *Ibid.*, p. IX.
[20] *Ibid.*, p. 100.
[21] U.S. Tariff Commission, *The Multinational Corporation and the World Economy*, p. 649.
[22] Musgrave Study, p. XIII.
[23] Ibid., p. XV.
[24] See Dale S. Jorgenson and Calvin D. Siebert, "A Comparison of Alternate Theories of Corporate Investment Behavior," The American Economic Review (September 1968), pp. 681–712.
[25] Richard Herring and Thomas D. Willett, "The Relationship Between U.S. Direct Investment at Home and Abroad," Rivista Internazionale di Scienze Economiche e Commerciali (1973, n. 1), p. 78. This is consistent with the conclusion drawn by the U.S. Tariff Commission, *op., cit.*, p. 328.

production,[26] a conclusion which has been supported by other academic researchers.[27]

Thus, it appears that an assumption of "no displacement" or "partial displacement" would be much more realistic than the "full displacement" assumption. And the use of either one of these more realistic assumptions in Professor Musgrave's model would lead to the conclusion that U.S. national income is higher because of U.S. foreign direct investment. This conclusion is consistent with the findings of a colloquium held by the National Science Foundation to assess the results of numerous research projects that have been conducted in an effort to determine the effects on the U.S. economy of U.S. foreign direct investment in manufacturing. Dr. Rolf R. Piekarz of that foundation said in a summary of the findings, "The available information, though incomplete, suggests that the United States, on net, benefits from [U.S.] foreign direct investment." [28]

d. Portfolio investment not affected

She assumes that the flow of portfolio capital into and out of the United States would not be affected by a decline in profits of U.S. firms—and such a decline would occur for U.S. multinationals because of the higher U.S. taxes. This assumption ignores both economic theory and empirical studies to the contrary.[29] The stock of portfolio capital invested in the United States by foreigners is very large, approximating $73 billion at the end of 1974, of which about $50 billion represented holdings of stocks and bonds of U.S. corporations.[30] In turn, U.S. private investors owned $29 billion of foreign stocks and bonds at the end of 1973,[31] a sum that could be increased dramatically if the foreign multinational corporations were to be made more profitable by being given a competitive edge over their U.S. rivals.

These probable detrimental effects on the flow of portfolio capital show the danger of relying on simple economic models and assumptions that do not capture important real-world effects.

3. Possible negative effects of the policy implied by Professor Musgrave

Although Professor Musgrave does not arrive at specific policy recommendations,[32] one could infer from her study that placing higher U.S. taxes on the foreign operations of U.S. multinational corporations would be desirable. Indeed, she raises this possibility.[33] But given the simplicity of her model and the unrealistic assumptions on which her results are based, the real-world effects of such an increase in taxation are likely to be considerably more negative than those she implies.

Under the present system, not only are the U.S. multinational corporations providing higher domestic earnings than other U.S. companies, but their domestic employment has been increasing while that of other manufacturing companies has been decreasing.[34] Higher taxes on the foreign earnings of such corporations would likely reduce the growth of the high-skilled (and high-paid) U.S. workforce for which they are creating jobs; because these firms and their related

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[26] The results will appear in a forthcoming book, Robert B. Stobaugh, et al., "Nine Investments Abroad and Their Impact at Home" (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1976). A summary of this study was published in Robert B. Stobaugh et al., "U.S. Multinational Enterprises and the U.S. Economy," in Bureau of International Commerce, U.S. Department of Commerce, "The Multinational Corporation," Volume 1 (Washington, D.C.: Superintendent of Documents, U.S. Government Printing Office, 1972); for a briefer version, see Robert B. Stobaugh, "How Investment Abroad Creates Jobs at Home," Harvard Business Review, September–October 1972. A fuller discussion of this methodology is in Piero Telesio, "Part I," of Robert B. Stobaugh, Piero Telesio, and Jose de la Torre, "The Effect of U.S. Foreign Direct Investment in Manufacturing on the U.S. Balance of Payments, U.S. Employment, and Changes in Skill Composition of Employment," Occasional Paper No. 4 of Center for Multinational Studies, Washington, D.C., February 1973.

[27] For example, see Robert C. Hawkins, "U.S. Multinational Investment in Manufacturing and Domestic Economic Performance," Occasional Paper No. 1, Center for Multinational Studies, Washington, D.C., February 1972.

[28] Rolf R. Piekarz (ed.), "The Effects of International Technology Transfers on the U.S. Economy," p. 4.

[29] Tamir Agmon, "The Relations Among Equity Markets: A Study of Share Price Co-Movements in the United States, United Kingdom, Germany, and Japan," The Journal of Finance (September 1972), p. 839.

[30] IMF Survey, Dec. 15, 1975, p. 366.

[31] Survey of Current Business, October 1975, p. 32.

[32] Musgrave Study, p. XIX.

[33] *Ibid.*, p. XX.

[34] Survey of Current Business, October 1973, p. 37.

activities would grow more slowly in the United States and would receive less knowledge from overseas.

As I discussed above, a reduction of investment abroad might have no effect on the level of capital investment in the United States. But if it did have an effect, this effect might well be a lower level of domestic capital investment, not a higher level, because of: (1) a decrease in the inflow of portfolio investment from abroad, (2) an increase in the outflow of portfolio capital from the United States, and (3) a reduction in the net inflow of earnings from U.S.-owned manufacturing facilities abroad, a reduction which would result because these facilities would become less profitable as their foreign competitors, which would pay lower total taxes than the U.S.-owned firms, expanded at a more rapid rate. This net inflow into the United States has been substantial, approximating $20 billion from 1970 through 1973.[35]

Another likely result of the decline in earnings of U.S. multinationals would be a decline in prices on the U.S. stock market, which—among other things—would affect the savings of millions of workers who have an interest in pension funds.

Even if the United States does profit from investments abroad by U.S. firms—and I believe that it does—the income redistribution effects within the United States are uncertain. Yet it would not seem to be a good policy to experiment with the healthiest part of the U.S. manufacturing sector in order to redistribute income. Other more direct means are available and, indeed, are being used. It is well to remember the admonishment of Professor Richard Caves of Harvard University, "Indeed, the optimal way to attain any income-distribution goal is never one that reduces the total income available for redistribution." [36]

Senator TALMADGE. The committee will stand in recess until 10 a.m. tomorrow morning.

[Whereupon, the committee was recessed at 10:45 p.m., to reconvene at 10 a.m., Tuesday, March 30, 1976.]

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[35] *Ibid.*, August 1974, Part II, pp. 16 and 22. Manufacturing accounts for 40 percent of the total. Most of this is from interest, dividends, and branch earnings, but it also includes royalties and fees from affiliated foreigners. For the rationale for including such royalties and fees, see Robert B. Stobaugh, et al., "Nine Investments Abroad and their Impact at Home" (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1976), Chapter 8.

[36] Richard E. Caves, "Effect of International Technology Transfers on the U.S. Economy," in Rolf R. Piekarz (ed.), The Effects of International Technology Transfers on U.S. Economy (Washington, D.C.: Superintendent of Documents, U.S. Government Printing Office, 1974), p. 37.

TAX REFORM ACT OF 1975

TUESDAY, MARCH 30, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Herman E. Talmadge, presiding.

Present: Senators Long, Talmadge, Ribicoff, Byrd, Jr., of Virginia, Curtis, Hansen, Dole, and Packwood.

Senator TALMADGE. The committee will please come to order.

The first witness this morning is Mr. John T. Higgins, vice president, Burlington Industries, for American Textile Manufacturers Institute, Inc.

Mr. Higgins, you may insert your full statement in the record and summarize it. Because of the multiplicity of witnesses, we have to invoke a time limit of 10 minutes on each witness.

STATEMENT OF JOHN T. HIGGINS, VICE PRESIDENT, BURLINGTON INDUSTRIES, FOR AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC., ACCOMPANIED BY JAY W. GLASMANN, COUNSEL

Mr. HIGGINS. My name is John T. Higgins. I am vice president of Burlington Industries, Inc. I am appearing before you today on behalf of the American Textile Manufacturers Institute, Inc. With me is Jay W. Glasmann, counsel to the tax committee of ATMI.

Our written statement summarizes the view of ATMI on a wide assortment of tax reform subjects, including double taxation of corporate earnings, capital gains, foreign income, DISC, research and development, and moving expenses. However, in the few minutes allotted to us for oral comment, I shall deal only with the subject of the tax treatment of capital cost recovery and the problems faced by the textile industry in obtaining funds for essential capital formation.

The textile industry, one of the Nation's largest employers in the manufacturing sector, faces rapidly growing capital needs at a time when outside sources of capital are either nonexistent or prohibitively costly. The organized equity and security markets, of course, are for all practical purposes closed to the textile industry. Much of the same can be said for outside loans.

A brief review of the working capital and capital equipment needs of the textile industry will emphasize the extremely serious nature of its financing problems. To begin with, the industry by its very nature

requires large sums of working capital to carry inventories and accounts receivable and these needs have increased enormously with the inflation of recent years.

As for capital goods expenditures, the cost of textile plant and equipment replacements for equivalent production currently runs from two to four times the cost of the item being replaced.

Add to this substantial investment in new equipment made necessary because of technological changes, foreign competition and shifts in market demands and one can easily appreciate the critical capital shortage the industry faces in replacing and expanding its productive facilities.

Let me give you two examples of the impact of technology and market demand changes on capital spending patterns in our industry. The first is the doubleknit story and the second relates to women's hosiery.

DOUBLE KNITS

Knitted fabrics for apparel have been around for centuries, and basically have been of the singleknit or jersey type.

However, in the early 1960's, the first double knit machine was developed. These machines actually knit two surfaces of fabrics and simultaneously join them together. This has the immediate benefit of making a much more stable fabric. It immediately caught on for women's outerwear, generally made from spun yarns of either wool or manmade fiber. By 1970, there were a total of 9,000 double knit machines in the United States. About that time, textured continuous filament polyester yarn was developed, and found to be highly suitable for use in double knits, both for men's and women's apparel. In the short span of 4 years, the number of machines installed in this country increased from 9 million to 24 million at a capital cost of over $600 million. The double knit machines purchased in 1972, 1973 and 1974 were much more sophisticated than the earlier double knit equipment; they were likewise more productive, and many times more expensive. Most machines in place in 1970 probably cost no more than an average of $15,000 each, whereas, by 1975, the large electronically controlled fine gage machines were selling for $70,000.

During 1973 and 1974, the prediction was often made by many that double knitting would substantially replace weaving.

By 1975, however, it had become apparent that very fine and desirable fabrics could be woven on looms using textured continuous filament polyester. Some of the features of the woven fabrics were that they were lighter in weight, were even more stable than double knits, less subject to pick, and could be woven in more attractive patterns. The effect has been very drastically to reduce the need for a large percentage of the existing double knit machinery. Perhaps as much as 40 percent of it is now idle surplus, and only those companies who have purchased the very finest gage, most modern equipment, are able to operate it profitably. Specifically, much of the machinery that was purchased in the early 1970's must now be considered obsolete. Dozens of double knit manufacturing plants have gone out of business in the last 12 to 18 months.

WOMEN'S HOSIERY

The hosiery industry presents a graphic example of an industry which over a span of 50 years has had its basic production machinery obsoleted twice by both technology and fashion with a swing from almost entirely seamless to almost all full-fashioned, and back again to entirely seamless. Since 1962, the trend has been toward seamless production. In the short time available today, I will mention only factors affecting the industry since that time.

In 1962, production of full fashioned hosiery was 25 percent of the total and seamless production was 75 percent. By 1970, full-fashioned had essentially disappeared from the scene and much expensive full-fashioned equipment simply had to be destroyed.

During this same period, more sophisticated and more productive seamless machines, basically going from single-feed to 8-feed machines, were being developed and sold. As a consequence, during the 10-year period prior to 1974, 40,000 single feed ladies hosiery knitting machines were withdrawn from production, and 45,000 2-, 4-, and 8-feed machines were purchased.

Superimposed on this rapid obsolescence of knitting machinery was the advent of panty hose, which accompanied the onset of the miniskirts in the latter part of the 1960's.

Because miniskirts expose a much larger area of the leg to runs and other hosiery failure, the consumption of hosiery reached a level of 135 million dozen in 1969, and the mix of the total production of hosiery shifted to 17 percent stockings, and 83 percent panty hose by 1972. As the fashion moved away from miniskirts to pantsuits, hosiery production began to drop sharply, and by 1975, production was at the level of 97 million dozen pairs or a reduction of 38 million dozen from the peak.

The end result was that industry found itself with machinery capacity in place that would produce 40 percent more hosiery than for which there was a market. Hence, the hosiery industry has proceeded through 3 or 4 years of declining production and losses, so that presently there are many fewer plants than existed in 1966. Our own company, for example, had 12 plants producing hosiery in 1971, and has only 2 plants today.

The above examples are only part of the textile industry's capital investment story, however. Hundreds of millions of dollars—and possibly even billions, depending on the strictness of the governmental standards that are applied—must be invested by the industry during the next few years in equipment to combat air, water, and noise pollution.

The most recent estimate is that the industry within the next 2 to 3 years will be forced to divert a very substantial percentage of its annual capital spending into nonproductive air, water, dust, and noise abatement facilities to comply with EPA and OSHA standards. These investments in so-called environmental protection facilities are, for the most part, nonproductive—they will not increase the industry's productive capacity at all—and they take dollars needed for plant modernization and expansion at a time when our Nation needs more productivity to combat inflation and to create jobs.

It is in this general context that ATMI continues to press for a tax environment in this country which is conducive to modernization and expansion of plant and equipment.

Our specific proposals are as follows:

1. The temporary increase in the investment tax credit to 10 percent should be further increased to 12 percent and made permanent.

2. A 5-year writeoff of all new machinery and equipment should be allowed as a matter of satutory right.

3. The cost recovery period assigned to factory buildings under ADR should not exceed 20 years, and the tax writeoff should be permitted under one or more of the accelerated methods. In addition, accelerated depreciation on industrial buildings held by business corporations should be eliminated as a preference item.

Full depreciation recapture would preclude any abuse of the adoption of this proposal.

4. The cost recovery provisions relating to pollution control facilities need substantial liberalization, including allowance of the investment credit, and a write-off period of not more than 3 years. In addition, such rapid amortization provisions should be eliminated as a preference item under the minimum tax provisions of the code. Similar write-off rules should be provided for expenditures to convert electrical and steam generating equipment from petroleum or natural gas to coal.

Thank you, Mr. Chairman and members of the committee, for this opportunity of appearing before you.

Senator TALMADGE. Senator Packwood?

Senator PACKWOOD. An argument is usually raised that foreign tax credit and deferral on foreign incomes is an incentive for American business to go overseas, especially to low-wage areas. One of the big complaints we have had is American manufacturers who have gone to Hong Kong, Korea, and Taiwan, for low wages. I notice you advocate keeping the foreign tax credit. Does the industry you represent have a number of manufacturing organizations overseas?

Mr. HIGGINS. Speaking for my own company, there are some subsidiaries which service the foreign markets exclusively where they are located. Our interest there is not because of the inability to export but the difficulty of exporting U.S. products to the European countries because of various trade barriers that we face—the value-added tax primarily.

We do not import textiles from Europe to the United States.

Our strength in Burlington Industries is the service and the variety that we provide to our customers—prompt delivery of a very wide ranging series of sales and products. We operate perhaps the largest private trucking operation in the world. We have our own trucks, making full truckload deliveries to various parts of the country—sending them to the west coast as well as the Chicago and New York area.

Senator PACKWOOD. Do you have any facilities in Asia for exporting materials back to the United States?

Mr. HIGGINS. We have had a partial interest in a carpet manufacturing plant in Japan. It is not a primary interest and I believe we have sold that now.

Senator PACKWOOD. You indicated the institute represents roughly 85 percent of the manufacturers. Would the answer be roughly the same for the other institute members?

Mr. HIGGINS. I believe so. My impression is that the imports that are from the low-cost countries are primarily apparel imports. I understand that industry, which the textile industry which I speak of services, has been hard pressed.

Senator PACKWOOD. Are those manufactured abroad or are those indigenous manufacturers?

Mr. HIGGINS. I do not know. As far as I know, they are manufactured by people abroad and are shipped into this country.

Senator PACKWOOD. Is Burlington involved in manufactured goods?

Mr. HIGGINS. No. Finished goods are made into apparel. We speak of finishing as fabric which has been dyed and so on.

Senator PACKWOOD. I was thinking in terms of ready-to-wear. I do not understand the grossing-up in undeveloped countries. What does "grossing-up" mean?

Mr. HIGGINS. The term, as I understand it now, is to equate lesser developed countries with those that are fully developed. The concept there is to recognize the income from which dividends were paid before concerning the tax credits that those earnings produced.

In other words, our tax credit is limited by a number representing foreign and the denominator representing total income.

If we consider as income that income generated within this country before taxes, the idea of grossing-up is to take the equivalent income tax before foreign taxes were paid abroad.

Mr. GLASMANN. Basically, it is adding the foreign tax to the amount of dividend received, so you just gross it up by the foreign tax attributable to the earnings that arrived at that dividend.

Senator PACKWOOD. Go through that slowly.

Mr. GLASMANN. Suppose you had $200 in a foreign subsidiary and that country has a 50-percent tax rate. The after-tax income we will assume is therefore $100, and you pay that $100 out as a dividend. If you gross-up that dividend, you add the $100 tax paid to the foreign country to that $100 dividend and say the U.S. company shall be considered as having received a dividend of $200, while it has a foreign Federal tax credit of $100. That is adding the foreign tax to the amount of dividend you receive.

Senator PACKWOOD. What do we do now?

Mr. GLASMANN. We do it in developed countries.

Senator PACKWOOD. I have no other questions, Mr. Chairman.

Senator TALMADGE. Mr. Higgins, the textile and garment industries were particularly hard-hit during the recession. Has that situation improved?

Mr. HIGGINS. There was a time when markets were quite dormant about a year ago. Since the June quarter of last year, we have seen a very steady improvement in sales and consequently in production. Employment is back very well comparable to what it was before the recession hit us.

Certainly some areas are slower in their recovery than others. Those areas of the industry that provide materials for draperies, for example, for upholstery fabric, are much slower in recovery, but even

they are showing improvement today. Employment today is back to about 950,000 in the industry. That is my understanding.

Senator TALMADGE. What was the peak prior to the recession?

Mr. HIGGINS. About 980,000, I think.

Senator TALMADGE. Has there been an equal recovery in the garment industry?

Mr. HIGGINS. I don't know.

Senator TALMADGE. I believe you stated the carpet industry has been somewhat slow.

Mr. HIGGINS. Yes.

Senator TALMADGE. To what extent are imports from low-wage countries profiting the textile industry?

Mr. HIGGINS. The primary way in which imports from low-labor countries affect the market is an indirect effect. The volume of goods being offered, for example, from China, at the moment, are coming in principally in the gray. They are not the finer count yarn fabric, but they are priced low. They have a depressing effect on the prices of higher quality goods.

For example, assume I will pay twice as much for a combed cotton handkerchief as I will for a carded handkerchief, say $1.50. If I can buy a cotton hankerchief for 50 cents or 40 cents, the price of the carded yarn handkerchief will have to decline to maintain the comparability between different yarns.

I believe that is the primary extent to which the markets would be affected today.

Going back 5 or 10 years ago, when you were considering seriously the worsted goods coming into this country from Japan, for example, those worsted goods were magnificent. They were beautiful, they were good, and they competed with the very best that could be produced in this country. As a result of this experience, I believe this country has lost at least 70 percent of its worsted production capabilities. Those companies have gone out of business. Burlington has withdrawn completely from the production of woolen goods as distinguished from worsted goods. Both are made from wool but woolens are one type or quality and worsteds are another. The worsted goods are those that you and I are wearing.

Senator TALMADGE. What percentage of your woolen goods are imports?

Mr. HIGGINS. I don't know. It is very high. Burlington had one of the very largest production facilities in Chattanooga, Tenn., which it closed completely—I can't remember the year.

Senator TALMADGE. I remember when you closed down your facility in Georgia. At the time, I believe it was the world's largest mill.

Mr. HIGGINS. That is correct. We had a great physical facility as a combination production center. Of course, we are all familiar with Marathon's experience. There are things you cannot do effectively as the foreigners. We face foreign competition on both counts. Foreign countries can produce as fine a product as we can. Our great forte is advancing technology so we come out with something new and better and produced in volume.

Some of these European countries make some of the most beautiful fine cotton sheer fabrics. You can read a newspaper through them,

but we produce nothing like that in this country. We produce specialization. America produces fine uniform quality goods in great volume. We can pride ourselves on that. The specialization will occur in some other countries and we are greatful for those, too.

Senator TALMADGE. Thank you, Mr. Higgins.

Senator CURTIS. Mr. Higgins, how important is the asset depreciation range, or ADR, to your industry?

Mr. HIGGINS. Very important. It is the means by which the capital investment is recovered. The speed with which it is recovered for tax purposes is most significant to an industry like this, whose borrowing capacity and capital-raising capacity are limited. If we recognize 50 cents of every dollar invested will ultimately produce a reduction in taxes, the sooner that is recovered, the shorter the borrowing period for the financing that occurs.

ADR has represented a very constructive step in my experience in the determination of what depreciation will be allowable. It is definite. It is fixed. Those lives are there, you conform to them and that is your depreciation. It is a far cry from the practice in 1941, I think it was, where annually there was a debate with an "engineer" from the Internal Revenue Service as to what the appropriate life was, with respect to business for that type of asset. It is the assurance that ADR provides and the moderately greater speed of writeoff that is most helpful.

Senator CURTIS. Is it true that a rapid writeoff for any facility is more realistic than is a writeoff over a prolonged period or a period that borders on straight line depreciation?

Mr. HIGGINS. Yes, it is.

Senator CURTIS. Let me give you an illustration everyone of us can understand. An automobile 1 year old would sell for much less than a brand new one. But if an automobile is in good condition, the value between one that is 5 years old and one that is 6 years old is not very great.

Mr. HIGGINS. That is true.

Senator CURTIS. It seems to me that, from the standpoint of accounting and sales price, and, indeed just accepting the plain facts of life, almost ever asset incurs its greatest real depreciation in its early life.

Mr. Glasmann, I would like to ask you a question. One witness here has suggested not only the repeal of ADR but also that a part of the investment credit be available on air incremental basis. That is, you would have a base and any investment beyond that base would entitle you to additional benefits. Do you believe that an incremental investment audit pose considerable administrative problems and would thus be complicated for most taxpayers?

Mr. GLASMANN. I think it would be very complicated. I think this was a suggestion made back perhaps in 1961 or 1962. The Finance Committee may have rejected it at that time for reason of administrative problems.

Senator CURTIS. The incremental approach could also place a taxpayer at a disadvantage with respect to his competitors.

Mr. GLASMANN. That is right.

Senator CURTIS. It seems to me that the Congress should do its very best to make the tax law definite and certain. Taxes are complex enough

in any event, but a hazy feeling as to the tax consequences of any transaction, or contemplated transaction, is discouraging to business and may in fact reduce employment.

Mr. GLASMANN. I think perhaps the most important thing about the investment credit is to make it permanent—certain. The on-again, off-again history of the credit has been very troublesome when people try to plan their expenditures 2 or 3 years down the line.

Senator CURTIS. An incremental investment credit would in my view merely add another element of uncertainty.

Mr. GLASMANN. That is right.

Senator TALMADGE. Senator Byrd.

Senator BYRD. I have no questions.

Senator TALMADGE. Senator Hansen.

Senator HANSEN. Because Senator Fannin had to go to another meeting and asked me to ask for unanimous consent that a statement of his be included in the record.

Senator TALMADGE. It is so ordered without objection.

[The statement follows:]

STATEMENT OF SENATOR FANNIN

Mr. Chairman, the Finance Committee today begins four days of hearings on the vital issue of encouraging new capital formation through enactment of savings and investment incentives. As my colleagues know, I have stated several times in the past that our nation's principal economic problem is the lack of adequate capital to meet the nation's present and future needs.

It is true that our most recent recession has blurred the clear recognition of this need by some individuals and organizations. Idle equipment and facilities appear to argue against investing in new capital goods. However, any such conclusion cannot be supported by the facts.

These pressing capital needs are further blurred by market economists publicly discussing the theory that there is no such thing as a capital shortage. The argument here is that at any given time someone is always going to be "crowded out" of the capital markets and that the amount of available capital will be efficiently distributed through the market mechanism. All of this is true in theory. The fact remains, however, that if we are to meet the continuing needs of the American people, we must establish federal tax policies which are directed towards these enormous capital needs.

Study after study concludes that the amount of capital needed throughout our economy during the next decade will far exceed any requirements of any previous decades.

The term "capital formation" often carries with it unpopular connotations from the politician's point of view. What capital formation really means is allowing the private sector to generate the funds needed to create new jobs for the unemployed and the underemployed, increasing the nation's productivity which has continued to decline both in absolute terms and in comparison with other industrial nations, improving our environment and working conditions and achieving energy independence.

Our energy needs continue to grow as does our dependence on foreign oil. The Congress must be aware of these needs. It has an opportunity to take positive steps in the legislation before us to move in the right direction in the area of domestic energy development.

Mr. Chairman, the House has not addressed in this bill the issue of a new tax policy in the area of capital formation. However, several provisions presently in H.R. 10612 concern me greatly as they would have a chilling if not negative effect on savings and investment, particularly in selected industries. In effect, the House has sent us a "no growth" bill. Only those who already have the advantages which our economy is capable of providing all Americans would benefit from a "no growth" policy. Entrepreneurs will continue to live well, but the averabe American will not. This is a natural extension of the policy which is deeply embedded in the House bill.

Mr. Chairman, allow me to make one further comment regarding the Committee's work in this area. I do not believe that any one single tax provision is capable of stimulating capital accumulation throughout our complex economy. This Committee must carefully examine the capital needs of the nation and fashion a far-reaching tax policy which meets those demands.

Senator HANSEN. In the summary, you mention incentives for industry sponsored research and that a tax credit should be given for industrial qualified research and development.

One of the earlier witnesses yesterday called attention to the fact that today, more and more applications for pacts are coming from foreign countries and from foreign nationals rather than from Americans which indicated to him the fact that our present tax laws and everything else were militating against the research and development programs by American industries. I suspect you might share that opinion; is that right?

Mr. HIGGINS. Yes, I believe that is so.

Senator HANSEN. I have read your statement. I have no other questions. I think you have made an excellent contribution.

Senator TALMADGE. Thank you for your contribution.

[The prepared statement of Mr. Higgins follows. Oral testimony continues on p. 1257.]

STATEMENT OF JOHN T. HIGGINS, ON BEHALF OF AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.

Mr. Chairman, my name is John T. Higgins and I am a Vice President of Burlington Industries, Inc. I am appearing before you to-day on behalf of the American Textile Manufacturers Institute, Inc. (ATMI) to present our views on various tax proposals presently before the Committee. Of principal concern to ATMI are the need for tax changes to encourage capital formation and the need to continue the current DISC deferral program substantially intact. With me is Jay W. Glasmann, counsel to the Tax Committee of ATMI.

ATMI represents approximately 85 percent of the nation's spinning, weaving, knitting and finishing capacity for processing cotton, wool, silk and man-made fibers. The textile industry plays a major role in the U.S. economy and is one of the largest employers in the manufacturing sector. It is also among the industries hardest hit by the recent prolonged recession, with employment during the peak of the recession falling by more than 15 percent and profits disappearing.

Textile plants are located in forty-seven states, and in many small communities the textile plant is the main source of jobs. In addition, many other industries, such as cotton growers, synthetic fiber manufacturers, the apparel industry, machinery manufacturers, dyestuff and chemical plants, transportation companies and electrical utilities, are, to a greater or lesser extent, directly involved with the textile industry. In essence, the needs and welfare of the textile industry reflect the larger needs and welfare of American industry in general.

I. CAPITAL FORMATION PROBLEMS OF THE TEXTILE INDUSTRY

One of the major problems which the textile industry is currently facing is finding sources to supply its ever-expanding capital needs. In the forthcoming decade, the textile industry expects a tremendous gap to occur running into the billions of dollars—between the capital needed by the industry and that which the industry is capable of raising under existing Governmental fiscal and monetary policies. This gap is expected to result from the following causes:

A. The historical problems of the textile industry in raising capital;

B. Continuing inflation and its effect on working capital and plant and equipment costs;

C. An increasing rate of technological obsolescence;

D. Governmental regulations in the fields of environmental protection, energy and labor safety; and

E. Foreign competition.

1. The historical problems of the industry and the impact of inflation

The textile industry has traditionally had one of the lowest profitability rates in American industry, and its relatively low rate of return has always made it especially difficult to raise significant amounts of capital from outside sources. Normally, a company will turn to the equity market in order to finance expansion. Unfortunately, the common stocks of textile companies have for many years sold well below their book value. Consequently, the equity market offers little opportunity to textile companies seeking outside capital.

In many industries when the equity market is unavailable or unsuitable, the industry members consider long-term debt as an alternative. However, textile company bonds are frequently rated BAA or BBB. As a result, such bonds are unattractive to the investing public. Consequently, the textile industry is largely dependent upon private placements with institutional investors for long-range financing and upon bank loans for short-term financing. There are generally numerous restrictions on the companies that utilize long-term debt from private placement loans. In addition, the Government's competition for funds to finance its deficits drives up the level of interest rates and absorbs a great deal of the demand for debt obligations.

With the availability of outside sources of capital strictly limited, almost all members of the textile industry have had to rely on internally generated sources to finance expansion and working capital. However, depreciation, the prime source for accumulating funds to replace obsolete plant and equipment, is a highly inadequate source of financing. Capital costs for equipment have been increasing astronomically since 1960, with the rate of increase being greatest in the last several years. With new machinery costing two to four times as much as the machinery it replaces, it is apparent that funds generated by depreciation at current levels are wholly inadequate to enable the industry to satisfy its requirements.

Much the same can be said with respect to increased working capital needs to finance inflated receivables and inventories. For a fully integrated weaving operation, for example, from 25 cents to 35 cents of working capital is required for each dollar of sales. The rapid inflation of 1973, 1974 and 1975, and to-day's continuing inflated cost level is requiring an ever-increasing amount of money for working capital in the industry to turn out the same number of units of production. A rough rule of thumb in our industry is that over the long run capital expenditures should be financed from funds generated from within, with long-term senior debt, when needed, to be used for working capital requirements. Unfortunately, inflated working capital needs and low after-tax profits in the industry in recent years have forced much of the funds generated from within to be locked up in additional working capital rather than being used for essential capital investments to modernize and expand the productive facilities of the industry.

2. Technological obsolescence

Compounding the effects of inflation, improvements in machine technology in the industry are causing machinery and equipment to become obsolete at an accelerating rate. There are several reasons for the increasing pace of technological obsolescence. First, the average hourly earnings of textile production workers have increased dramatically, with a 45 percent increase occurring since 1970, with nearly half of that since 1973. Furthermore, there has been a corresponding growth in the cost of fringe benefits. These rising labor costs have also occurred at a time of increasing scarcity of available labor. As a result of these factors, most manufacturers are forced to consider technological improvements which can contribute to greater labor efficiency.

The technology of textile machinery is also influenced to a large extent by the fibers being processed. To a substantial degree, a different type of equipment is required for processing each of the various types of fibers. A brief discussion of what has transpired in recent years regarding the changes in consumption of the three major fiber groupings will illustrate this situation. In the thirteen-year period from 1960–1973 (before the recession), total annual fiber consumption has almost doubled. However, cotton fiber consumption fell 10 percent from its 1960 level and wool fiber consumption fell by roughly two-thirds of its 1960 volume. The balance, accounted for by man-made fibers, climbed 450 percent.

This radical shift in the types of fibers used has had a dramatic impact on the increasing rate of technological obsolescence.

Fashion trends have also affected technology in the textile industry. For example, there has been an important trend toward usage of more leisure apparel. Demand has also increased for easy-care fabrics. Other recent developments in fashions include the demand for long-pile shag carpets, knitted outerwear and cotton/polyester blends. Each of these developments has required companies to invest in newer and more expensive machinery.

3. *Government regulations*

A substantial contributor to the existence of a shortage in available capital is the tremendous surge in capital needed to satisfy Government regulations in such areas as noise, air and water pollution. The capital needed by the textile industry to comply with various Government pollution-control regulations is estimated in the billions of dollars.

The energy crisis is also having a significant impact on textile capital expenditures. As shortages of natural gas and oil occur, many plants and equipment must be converted to coal. Such conversions are costly and do not ordinarily improve productive efficiency. In fact, the conversions frequently lower efficiency and profitability. Nevertheless, for Federal income tax purposes, such expenditures must be capitalized and depreciated over extended periods. As a consequence, Governmental regulations are a prime contributor to the industry's capital crisis by requiring unprecedented amounts of non-productive capital expenditures.

4. *Foreign competition*

Another important reason that textile companies must expend large sums of capital over the next decade is the need to remain competitive with foreign manufacturers. Textile products produced worldwide at widely varying national cost levels compete fully in world trade at all levels of processing.

American textile products are not only competing against lower-cost foreign-made products, but American companies are operating under a tax system which strongly discourages capital investment compared to the tax systems applicable to our major foreign competition. For example, most major industrial countries have imputation income tax systems under which corporate dividends are not taxed to shareholders. Most of these countries also have a value added tax which is rebated on exports. In addition, investment allowances and credits, and accelerated capital cost recovery in most major industrial countries allow for a far more rapid recovery of capital investment than is available under the U.S. tax system. In addition, outright grants are frequently made for reequipment and for employee training by foreign countries.

Thus, the U.S. textile industry faces severe competition from foreign producers. In many instances, because of these foreign producers' cost and tax advantages, the U.S. must compete more on the basis of quality and style than price. Such competition requires enormous outlays for the most advanced, computer-controlled machinery and equipment.

While the experts may continue to debate the size of any capital shortage for American industry as a whole, there can be little doubt of the magnitude of the problem which faces the textile industry. Rapid technological changes, inflation, and competition from other industrialized nations make it imperative that the United States further encourage through our tax laws continued and increasing investment by industry in this country in the most modern production facilities. It is in this general context that ATMI must voice its continued strong opposition to proposals in Congress and elsewhere to repeal the investment credit and the Asset Depreciation Range (ADR). These provisions, adopted in 1971 by the Congress, simply brought our capital cost recovery allowances more in line with the allowances available to our major international industrial competition. Much more remains to be done to further shorten the tax write-off period for machinery and equipment, to assist in financing pollution abatement projects, and to improve cost recovery allowances for industrial buildings.

5. *ATMI recommendations*

ATMI believes that one of the principal solutions to the problem of a shortage in investment capital would be a shift in Federal tax policy to an approach

which promotes greater savings and capital investment, and more rapid capital cost recovery. These are the prime areas which need attention if American business is to remain competitive in world markets and if American industry is to expand job opportunities in this country. Our specific proposals are as follows:

(a) Capital Cost Recovery Allowances for Machinery and Equipment

A five-year capital cost recovery write-off of new machinery and equipment as a matter of statutory right should be adopted. The recovery of costs at a faster rate than presently allowed under ADR, of course, does not increase the taxpayer's total deductions; instead, it merely allows the same deductions over a shorter period of time.

The President's Task Force on Business Taxation, which compiled information in 1969 and 1970 showing capital cost recovery allowances on industrial machinery and equipment in the United States and eleven other nations at the end of the first, third and seventh taxable years, demonstrated that we lagged far behind all of our principal competitors under the law as it existed in 1969 and 1970, which did not include the investment credit and ADR. A study done by ATMI in 1973 showed that despite our 1971 changes, the United States, during the early years of cost recovery (which are by far the most important) still fell behind all our major industrial competitors, including countries such as Japan, France, Canada, Belgium and the United Kingdom. Our understanding is that even with the present 10 percent investment credit and ADR, capital cost recovery allowances for most industries in this country today still lag behind those in all major industrial nations with the exception of West Germany. This certainly was true in the case of the textile industry until last week when the Internal Revenue Service revised downward the asset guideline periods applicable to various asset groupings in the textile industry under the ADR system. The new asset guideline periods for the textile industry, applicable to assets placed in service after December 31, 1975, reflect a two-year study of the textile industry by the Office of Industrial Economics of the Treasury Department.

(b) Capital Cost Recovery Allowances for Industrial Buildings

The cost recovery period assigned to factory buildings under ADR should not exceed 20 years, and the tax write-off should be permitted under one or more of the accelerated methods.

Modern industrial plants represent an ever increasing portion of investment in productive facilities. In the textile industry, for example, the building components of a modern finishing plant may easily exceed 30 percent of the total cost of plant and equipment. The United States lags far behind major competitors abroad in its capital cost recovery allowances for such industrial buildings.

Indeed, instead of improving the Federal tax policy towards capital cost recovery allowances for industrial buildings, the Congress has moved in the opposite direction in the past five years. The President's Task Force on Business Taxation reported in 1970 on the growing disparity in treatment of industrial buildings under the United States and foreign tax laws. Nevertheless, primarily because of concern for the real estate shelter problem, the Congress prohibited taxpayers from depreciating buildings under either the double declining balance method or the sum of the years digits method. In addition, it made the excess of accelerated depreciation over straight-line depreciation a tax preference item in the minimum tax. Finally, although it is optional with the taxpayer whether to include its real estate under an ADR election, any real estate included under an ADR election must at the current time be depreciated either over forty-five years, the old guideline life, or under a facts and circumstances test until the Treasury promulgates new class lives for real estate.

ATMI is disturbed both by the current situation and the trend in this area of the tax law. The present restrictive depreciation rules on industrial buildings place American companies at a significant competitive disadvantage compared with businesses operating in other countries. Most of the industrialized nations of the world have far more liberal tax policies towards recovery of capital investment on industrial buildings.

By way of example, France and Canada use a cost recovery period of twenty years and the United Kingdom sixteen years. However, these shorter cost recovery periods abroad for industrial facilities are only the tip of the iceberg. Italy, Japan and Sweden apply their building write-off rules only to the structural shell

of the building, allowing much faster cost recovery for facilities providing for heating, plumbing, air-conditioning and power requirements, components which must be treated as part of the building under the more restrictive U.S. rules. The United Kingdom also allows the cost of building facilities such as heating and air-conditioning to be recovered at a rate faster than the building shell.

France provides special accelerated depreciation of 25 percent of the cost of new buildings used for industrial and commercial activities which have been approved by the Ministry of Economics and Finance. Italy provides for accelerated depreciation on 40 percent of the cost of new buildings, limited to 15 percent in any single year. Japan permits a special first-year depreciation allowance up to 20 percent of the cost of factory buildings which turn new technological ideas into commercially necessary products. The United Kingdom provides an initial allowance of 40 percent of new factory buildings. In addition, the U.K. provides cash grants up to 55 percent of the cost of industrial buildings constructed in high unemployment areas. Canada provides incentive grants up to 25 percent of the the cost of a new plant plus up to 20 percent of the cost of modernizing and expanding existing plants in certain undeveloped areas.

ATMI urges that accelerated depreciation be restored as it applies to industrial buildings owned by legitimate business corporations. Full depreciation recapture would preclude any abuse of the adoption of this proposal. If the Congress considers real estate tax shelters a problem, then it should attack the problem in a way that does not penalize ordinary businesses which are not involved in tax shelters. In addition, ATMI supports a 55 percent shortening of the old guideline lives for industrial buildings. ATMI believes that such action would already have been taken by the Treasury Department pursuant to its authority under ADR, but for the prevailing fear that it will be accused of being soft on tax shelters. There are many ways that the tax shelter problem can be isolated from the problems which we are raising and ATMI suggests that the Congress pursue these alternatives.

(c) *Capital Cost Recovery for Pollution Abatement Facilities and Energy Conversion Expenditures*

The cost recovery provisions relating to antipollution facilities need substantial liberalization. If there is any provision in the tax law which has failed to produce its intended result it has to be the rapid amortization provisions of § 169 dealing with certain pollution abatement facilities servicing plants in operation before 1969. Under present law such facilities, under numerous restrictive conditions, qualify for a special five-year amortization. Taxpayers making such an election must forego the investment credit.

In our experience, few taxpayers use § 169 because the availability of the investment credit and ADR generally far outweighs the benefits of five-year amortization. Moreover, the existing provisions are fraught with complexities. The fifteen-year rule in determining the amortizable base should be eliminated. The disqualifying feature of the present law which discourages modernization or expansion of old plants serviced by pollution abatement facilities eligible for rapid amortization should also be eliminated. However, the two most important changes which ATMI believes must be made if the provision is to be at all viable are to allow the investment credit on such facilities and to reduce the five-year amortization period to three years. Finally, ATMI sees no justification for the inclusion of the rapid amortization of pollution control facilities in the list of tax preferences under the minimum tax.

It should be noted that other industrial countries afford special treatment for pollution control facilities. Canada allows pollution control equipment to be fully depreciated over two years. France allows an additional 50 percent depreciation allowance for the first year in which buildings used for pollution control are placed in service. In Japan, pollution control facilities enjoy favorable cost allowance recovery treatment, including a 50 percent first-year write-off, in addition to regular depreciation, and in West Germany pollution control facilities installed in old buildings may be depreciated up to 50 percent of cost in the first five years after installation, in addition to regular depreciation.

Another area analogous to pollution control to which ATMI believes the rapid amortization principle should be extended is the treatment of energy conservation and conversion expenditures. Such expenditures are quite similar to pollution control costs in that (1) they contribute to solving a national problem, (2) in

many instances the expenditures are mandated by Government regulation, and (3) the expenditures do not normally improve a company's efficiency and profitability. For these reasons, ATMI believes that the Government through the tax system should bear a portion of the cost of such expenditures. However, as in the case of pollution control facilities, a relatively short amortization period is of little value unless it is accompanied by the availability of the investment credit.

This type of approach could also be expanded to cover similar expenditures required by a variety of other Government regulations. Expenditures to satisfy OSHA rules and EPA noise standards are prime examples of regulations which will require enormous exepnditures while returning little or no benefits to textile companies. In addition, in order to encourage development and use of more energy efficient equipment and processes, tax incentives should be made available for such equipment and processes. Specifically, any capital expenditures made for the primary purpose of improved measurement or control of energy usage, or for the primary purpose of energy conservation, should be assigned a life of three years in addition to the regular investment credit.

(d) *Increase in investment credit*

The "temporary" increase in the investment credit to 10 percent should be further increased to 12 percent and made permanent. In addition, at present the maximum credit which may be claimed in any year is limited to $25,000 plus one-half of the excess of tax liability for the year over $25,000. ATMI believes this limitation should be amended to permit the credit to offset the entire tax liability in any year, with the same rule to apply to carrybacks and carryforwards of unused credits, and with the amount of any unused credit still available at the end of the carryover period to be refunded to the taxpayer by the Treasury Department.

In conclusion, the combination of a 12 percent investment credit and a 55 percent shortening of building lives should be viewed as minimum first steps towards bringing this nation's capital cost recovery allowances up to levels needed to meet the capital formation challenge of the next decade. Much more needs to be done. This is particularly true so long as we must live in an atmosphere of inflation which constantly erodes the replacement value of our cost recovery allowances. ATMI, therefore, urges the Committee to undertake an in-depth study of the feasibility of providing some form of replacement cost depreciation for capital assets.

6. Additional changes in the tax laws that would stimulate capital investment

(a) *Double taxation of corporate income*

Another area worthy of your Committee's attention is the double taxation of corporate income under current law. Several major industrialized nations, such as Great Britain, France, Belgium, Canada and Japan, have enacted an imputation tax system whereby shareholders are able to credit a portion of the corporate tax paid by their corporation against the individual income tax they must pay on the dividends received from their corporation.

While ATMI has focused considerable attention on proposals to promote capital recovery, it is quite apparent that the textile industry in particular and business in general are in desperate need of outside sources of funds. One of the most effective methods of making equity financing more attractive is by reducing the double taxation of corporate dividends. This can be accomplished in a variety of ways, such as by treating the corporation as a conduit for tax purposes, allowing dividends as a corporate tax deduction, or applying the imputation tax system presently being used in other nations. ATMI believes that your Committee should examine all of these alternatives with a view to stimulating capital investment which will create badly needed jobs for American workers. In this regard, ATMI supports the specific proposals of the Treasury Department dealing with this important subject which were presented to this Committee recently by Secretary Simon.

(b) *Taxation of capital gains*

Consistent with its position on stimulating equity investment, ATMI supports the various proposals which have been made to reduce the capital gains tax

rate as the length of the holding period of assets increases. In particular, we endorse the Treasury Department's recent proposal for a sliding scale approach to capital gains taxation. The high prevailing rate of inflation in this country has resulted in the creation of large amounts of "illusory profits" upon the sale of capital assets. Thus, from an economic standpoint, the vast majority of gains realized from the sale of capital investments is taxed too heavily. Furthermore, the incidence of taxation on capital gains in the United States is relatively high when compared to the other major industrialized nations of the world. Incentives for capital investment are extremely important if American business is to maintain a competitive position in world markets.

ATMI is strongly opposed to efforts to tax capital gains as ordinary income and to tax unrealized appreciation on capital assets at death.

In considering the proper tax treatment of capital gains, many commentators tend to overlook the important problem of integration with the minimum and maximum taxes. ATMI suggests that the effects of any direct reduction in capital gains rates will be diluted to the extent that conforming amendments are not made to the minimum tax preference items and the maximum tax on earned income. This results from the fact that under the present structure of the tax law the so-called untaxed portion of capital gains is taxed as a preference item under the minimum tax, and preference items in excess of $30,000 each year, in turn, reduce dollar for dollar the tax benefit otherwise available to an individual under the 50 percent maximum tax on earned income. It would be inconsistent to reduce the capital gains tax rate as a means of encouraging equity investment, and then offset the intended benefit by automatic operation of the present provisions of the minimum and maximum taxes.

II. TAXATION OF FOREIGN INCOME

A. DISC

The current DISC tax deferral program provides a strong incentive for exporters. The available evidence indicates that the tax deferral incentives offered by the DISC program have been significantly responsible for the substantial increase in United States exports over the last few years. Increased exports, of course, mean more United States jobs and a more favorable United States balance of payments. Accordingly, the DISC tax deferral incentives should be continued in their present form in order to help assure that the United States maintains a competitive position in worldwide trade.

The benefits available under the DISC tax deferral program are of crucial importance to the textile industry at this particular time. The United States textile industry is just beginning to recover from the most severe worldwide recession that has been experienced in two decades, which recession has severely affected the worldwide textile industry. More and more countries, including the Common Market bloc, are taking steps to encourage domestic production while restraining textile imports.

For the above reasons, ATMI, favors the retention of tax deferral for export income of DISCs. It is urged that current proposals to eliminate or severely curtail the deferral program be rejected.

B. Income of foreign subsidiaries

Some commentators have suggested that the United States should tax currently all unrepatriated income of controlled foreign corporations. ATMI believes that Subpart F is effective in preventing any deferral of tax in abuse situations. Moreover, the recent amendments to these provisions enacted in the Tax Reduction Act of 1975, such as the repeal of the minimum distribution exception and the investment in less developed countries exception and the reduction in the 30 percent test to 10 percent, significantly tightened the Subpart F rules. Any further changes clearly would be unjustified at this time, with the possible exception of current taxation of profits derived from products imported into the United States.

C. Foreign tax credit

ATMI is opposed to various legislative proposals that would severely limit the foreign tax credit. Changes in this area should be limited to those contained in the proposed amendments to the foreign tax provisions of the Internal Revenue Code in H.R. 10612, currently being considered by this Committee, including repeal of the per country limitation, the gross-up of less developed country

corporations' dividends, the recapture of foreign losses, and a limitation on the foreign tax credit available with respect to foreign capital gain income. Amendments beyond this point would significantly harm American business abroad.

D. Possessions corporations

The existing tax treatment of § 931 corporations should be retained or, in the alternative, proposed new § 936 of the Code contained in H.R. 10612, currently being considered by this Committee, should be enacted. We believe that the Committee is well aware of the detrimental economic effects that repeal of § 931 would have on Puerto Rico and our other possessions.

E. State taxation of foreign source income

ATMI is also concerned about the ability of states to tax the foreign source income of multinational corporations doing business in the state and would urge this Committee to propose uniform Federal legislation which would prohibit states from taxing foreign source income.

The two most common methods used by a few states to tax foreign source income of multinational corporations doing business within the state are application of the so-called "unitary business concept of taxation on a worldwide basis and the inclusion of dividends received from its foreign affiliates in the tax base of a multinational corporation doing business within the state. In order to prevent the clear inequity which results from the application of these principles, uniform Federal legislation which would preclude states from taxing dividends from foreign sources and from applying the unitary business concept to the income of foreign corporations is urgently needed. Such legislation is essential to prevent state taxing practices from thwarting the Federal Government's international tax policy, which is reflected in the currently existing Federal income tax laws and is designed to prevent double taxation in the international area.

III. MISCELLANEOUS TAX PROVISIONS

Other areas of the tax law which ATMI believes should receive your Committee's attention during tax reform deliberations include the following:

A. Public disclosure of private rulings, and technical advice memoranda

A legislative proposal to make unpublished letter rulings and technical advice memoranda available for public inspection is currently before this Committee. ATMI considers most aspects of the proposed legislation favorable in that it attempts to accomplish in an administratively workable fashion the competing goals of making private rulings and technical advice memoranda available for public inspection while at the same time protecting taxpayers' privacy. Particularly favorable aspects of the proposed legislation include the proposal to make available only expurgated copies of private rulings and technical advice memoranda and to exempt from disclosure all material submitted by taxpayers in connection therewith and the proposal generally to defer disclosure of a private ruling until after the proposed transaction has been consummated.

ATMI is concerned, however, that the proposed legislation does not adequately protect the privacy of closely-held corporations and their shareholders. Under the proposed legislation, in all instances except those in which a required ruling or a technical advice memorandum are involved, the name and address of the taxpayer and all persons named in the ruling must be disclosed. In many cases, a ruling issued to a closely-held corporation will also disclose the names of the individual shareholders, and their privacy will be invaded. Invasion of their privacy will also occur when, among those in a particular area or industry, the name of a closely-held corporation is readily identifiable with the names of the individual shareholders. Such names should be exempt from disclosure under the exemption of the Freedom of Information Act which prohibits clearly unwarranted invasions of personal privacy. The proposed legislation contains a provision which would permit the Service to eliminate names as an alternative to deleting exempt material from a ruling, if it would aid disclosure; however, it cannot be assumed the Service would use this procedure to protect the privacy of closely-held corporations and their shareholders.

Another defective aspect of the proposed legislation is its failure to afford applicants for non-required rulings a right of court review if they disagree with the Service's proposed disclosure. This proposal to leave to the Service the final decision whether material is exempt from disclosure, although much preferable to the Service's proposal to require a blanket waiver of confidentiality in ob-

taining a ruling, is discriminatory in that it distinguishes too much between the voluntary and required ruling program. As is provided in the case of a taxpayer who seeks a required ruling, a voluntary ruling request should carry with it the right of court review of a Service decision not to protect certain material which a taxpayer considers exempt from disclosure.

B. Minimum tax

Business corporations should be removed from the coverage of the existing minimum tax. The nature of the tax is such that it only affects companies which are financially distressed. This is hardly the group the Congress intended to tax more heavily. In addition, the same tax considerations do not exist with respect to business corporations as with wealthy individuals who attempt to shelter their income from highly progressive tax rates.

With respect to the minimum tax as it applies to individuals, we believe that suggestions to increase the minimum tax and to enlarge the category of tax preferences and reduce the offset for taxes paid are misplaced. Instead, ATMI believes that the Treasury Department's proposal for an alternative minimum tax is a better approach to solving the problem of high income individuals who pay little or no income tax.

C. Incentives for industry-sponsored research

The intense competition from foreign manufacturers which is evidenced by the United States' frequent balance of trade problems makes it essential that American industry increase research and development to improve the quality and cost of products which compete in the world marketplace. Accordingly, ATMI recommends that § 174, dealing with deductions for research and development, should be expanded to include a tax credit for qualifying industry-sponsored research and development projects.

D. Tax treatment of real estate

If the Committee deals with the tax shelter aspects of real estate investments currently before the Committee, such efforts should be carefully circumscribed so as not to adversely affect the construction of plants and office space by *bona fide* industrial corporations.

E. Moving expenses

The current provisions relating to job-related moving expenses of individuals are too complex and difficult to understand. The most direct approach to accomplishing simplification would be to provide an exclusion from gross income for reimbursed moving expenses.

If the present complex treatment is retained, however, the provisions should be liberalized and simplified. ATMI supports doubling of the present dollar limitations, a return to the former twenty-mile rule and a thirty-day extension in the existing rules on temporary living expenses at the new job location. In addition, the present one-day temporary living allowance while packing at the old job location should be increased to five days.

F. Adjustments relating to changes in method of accounting

Section 481 of the Code provides for certain adjustments when a change in method of accounting occurs. Under the present law the statute of limitations is opened for the Government alone in order to make adjustments retroactive to January 1, 1954. Today this provision constitutes a twenty-two-year reopening of the statute of limitations and it continues to increase with each passing year. As time passes, fewer and fewer companies will have retained the necessary records dating back to 1953. Accordingly, ATMI believes that the cutoff date provided should be moved forward so that it is never more than six years prior to the adjustment year.

Statement of American Textile Manufacturers Institute, Inc.—Summary of Recommendations

1. Capital cost recovery allowances for machinery and equipment

To take account of technological changes and inflation, and to bring capital cost recovery allowances closer to those granted by other major industrialized nations, the cost recovery period for all new machinery and equipment should be no more than five years.

2. CAPITAL COST RECOVERY ALLOWANCES FOR INDUSTRIAL BUILDINGS

For the same reasons, accelerated depreciation methods should be reinstated for factory buildings and the cost recovery period applicable to new industrial facilities should be reduced to twenty years. The minimum tax should be made inapplicable to *bona fide* industrial corporations or, at least, accelerated depreciation on industrial buildings held by such corporations should be eliminated as a preference item.

3. CAPITAL COST RECOVERY FOR POLLUTION ABATEMENT FACILITIES

The present five-year amortization provisions applicable to anti-pollution facilities should be simplified and liberalized by (a) reducing the amortization period from five years to three years, (b) eliminating (i) the fifteen-year rule for determining the amortizable base and (ii) the disqualifying feature which discourages modernization or expansion of plants in operation prior to 1969 serviced by pollution equipment eligible for rapid amortization, (c) allowing the investment credit for pollution control facilities receiving write-off treatment, and (d) eliminating rapid amortization as a tax preference item.

4. CONVERSION OF ELECTRICAL AND STEAM GENERATING FACILITIES

Similar rapid amortization and investment credit treatment should be authorized for expenditures incurred to convert electrical and steam generating facilities from petroleum or natural gas to coal. In addition, in order to encourage development and use of more energy efficient equipment and processes, tax incentives should be made available for such equipment and processes. Specifically, any capital expenditures made for the primary purpose of improved measurement or control of energy usage, or for the primary purpose of energy conservation, should be assigned a life of three years in addition to the regular investment credit.

5. INVESTMENT CREDIT

The temporary 10 percent rate for the investment credit should be increased to 12 percent and made permanent.

6. DOUBLE TAXATION OF CORPORATE INCOME

Corporate shareholders receiving dividends should be allowed a credit relating to the corporate tax on the earnings distributed along the lines of the imputation system applicable in other major industrial countries. In the alternative, the corporation should be permitted to deduct dividend payments.

7. CAPITAL GAINS

Congress should reject proposals to increase capital gains rates, tax capital gains as ordinary income, or tax capital gains at death. Any increase in the holding period for long-term capital gains treatment should be accompanied by a reduction in the rate of tax related to the length of time the property is held.

8. TAXATION OF FOREIGN INCOME

(a) *DISC.*—To encourage exports, the present DISC deferral program should be retained.

(b) *Income of foreign subsidiaries.*—Congress should not go beyond present law in taxing undistributed profits of foreign subsidiaries, with the possible exception of profits derived from products imported into the United States.

(c) *Foreign tax credit.*—Changes in this area should be limited to repeal of the per country limitation, the gross-up of less developed country corporations' dividends, the recapture of foreign losses, and a limitation on the foreign tax credit available with respect to foreign capital gain income.

(d) *Possessions corporations.*—The provisions of § 931 should be retained as incentives to economic development of Puerto Rico and U.S. possessions. In the alternative, the possessions corporation provisions contained in H.R. 10612 should be adopted.

(e) *State taxation of foreign source income.*—Congress should adopt uniform Federal legislation which would preclude states from taxing the foreign source

income of multinational corporations by applying the "unitary business" concept of taxation on a worldwide basis or including dividends received from foreign affiliates in the tax base of multinational corporations doing business in a state.

9. PUBLIC DISCLOSURE OF PRIVATE RULINGS AND TECHNICAL ADVICE MEMORANDA

Proposed legislation to make unpublished letter rulings and technical advice memoranda available for public inspection should include provisions to protect the privacy of closely-held corporations and their shareholders and to permit court review in all instances of the Service's decision whether certain material is exempt from disclosure.

10. INCENTIVES FOR INDUSTRY-SPONSORED RESEARCH

A tax credit should be given for qualifying industry-sponsored research and development projects.

11. TAX TREATMENT OF REAL ESTATE

Any legislative changes designed to limit real estate tax shelters should be carefully devised so as not adverely to affect construction by *bona fide* industrial corporations of their own buildings.

12. MOVING EXPENSES

The present provisions concerning employees' reimbursed moving expenses should be simplified and liberalized by eliminating reimbursed moving expenses as an item of gross income or, alternatively, by:

(a) Doubling the present dollar limitations;
(b) Reinstating the twenty-mile rule;
(c) Increasing the thirty-day limit on temporary moving expenses to sixty days.

13. ADJUSTMENTS RELATING TO CHANGES IN METHODS OF ACCOUNTING

Section 481 should be amended to reduce to not more than six years the period of prior years for which the statute of limitations can be reopened by the Government in the case of changes in accounting methods.

Senator TALMADGE. Our next witness is Mr. Charles Stewart, president, Machinery and Allied Products Institute.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE, ACCOMPANIED BY FRANK HOLMAN, STAFF COUNSEL

Mr. STEWART. In addition to our full statement, but not to be submitted for the record, we offer for committee and staff use the full texts, enclosed in a binder, of the basic economic and tax studies which are referred to in our statement. I would not presume to ask they be included in the record but they are available.

Senator TALMADGE. They will be filed with the committee.

Mr. STEWART. I would like to ask that a 1-page supplement to our statement be included in the record. It refers to and summarizes inflows and outflows arising from U.S. direct investment abroad during the period 1960 to 1975. It makes the point that from 1973 through the first three quarters of 1975, repatriated earnings to the United States which are subject to U.S. taxation at the time of repatriation, totaled $40 billion plus and that income was almost $25 billion less than the outflow. This is a dramatic demonstration of the payoff from U.S. direct investment abroad and, in itself, argues strongly against

penalizing any further through the tax system or by other means U.S. foreign direct investment and earnings therefrom.

Senator TALMADGE. Without objection, that insertion will be made.

[The supplement follows:]

INFLOWS AND OUTFLOWS ARISING FROM U.S. DIRECT INVESTMENT ABROAD, 1960–75

The table below shows U.S. direct investment abroad for selected periods since 1960 and repatriated earnings from these investments. We have taken three-year totals in order to avoid distortions which otherwise would result from erratic year-to-year fluctuations.

U.S. direct investment abroad is defined as equity investment of 10 percent or more.

Concerning the increase in remittances to the U.S. of foreign investment earnings during 1973–75, this reflects in part the exceptionally large increase in earnings of U.S. affiliates abroad during the early part of the period due both to rapid inflation and very strong business conditions. None of the figures in the table are adjusted for inflation, which has been substantial in recent years. It should also be noted that the devaluations of the dollar in terms of foreign currencies since late 1971 permitted more dollars to be remitted to the U.S. for a given level of foreign currency earnings.

[In millions of dollars]

	1960–62	1970–72	1973 1st 3 quarters (1975) [1]
U.S. direct investment abroad	4,926	13,089	16,436
U.S. income from direct investment [2]	10,219	23,191	41,329
Income less outflow	5,293	10,102	24,893

[1] 1975 figures are seasonally adjusted.
[2] Includes fees and royalties from affiliated foreigners.

Source: U.S. Department of Commerce.

Mr. STEWART. Our statement focuses on capital formation and those aspects of the tax system, both corporate and private, which have a bearing on capital formation, capital investment and improvement in productivity and the standard of living. The MAPI studies that I have referred to and offered to the committee staff go directly to that issue.

The Institute represents the capital goods and allied equipment industries and some major user industries of such capital equipment.

I am accompanied by our staff counsel, Mr. Frank Holman, whom I would like to introduce for the record.

First, let me make a quick philosophical observation. It has always been my feeling when we talk about tax reform or tax revision that there is a temptation to think solely in the negative. If we look at these terms in their true meaning, they should include affirmative actions in the form of new concepts and, where appropriate, removal of disincentives. Also, some are tempted in this area to use misleading semantics such as "loopholes," "tax shelters," "giveaways," and so forth. It all depends, of course, as to whose ox is being gored as to what is a loophole or tax shelter.

I have also felt a responsibility not to be completely self-serving in appearing before such a distinguished forum as this. I want to speak briefly regarding the personal income tax, not alone as it affects

capital formation, but the tax as such, particularly as it affects certain income brackets. I will come back to this subject.

Let me turn to certain specifics that I would like to emphasize within your time limit of 10 minutes. First of all, we feel the Senate Finance Committee should at least go along with the House-passed extension through 1980 of the current 10-percent investment tax credit. Actually we would prefer permanence, a response that has already been brought out in questioning, and we believe also that a 12-percent investment tax credit would be preferable and thoroughly justified. But at least we urge that the House-passed extension of the credit be adopted.

In connection with a related matter, we have a real problem in this country now with regard to the funds that are siphoned off from what are called economic investments because of requirements by law in the field of pollution, antipollution, safety, and so on. This is not to demean the worthwhile and the very necessary objectives of these requirements.

The fact remains, however, that approximately 10 percent or more of total capital funds available to American industry are being used in these specialized areas and, therefore, are unavailable for so-called economic or productive investment. We think something should be done about that. As pointed out by the previous witness, the prior law was totally unsatisfactory.

One could go two routes in attempting to correct this problem. Using an investment credit of, say, 15 to 20 percent for this type of equipment is one approach, or you could develop an improved statute along the lines of special amortization which was in a defective form on the statute books previously.

I refer now to the subject I mentioned earlier in terms of trying to look at the problems of others and not just the problems of corporations.

In my judgment, we face in this country today, an almost confiscatory tax impact in the middle-income brackets. Middle-income tax brackets, I would define as $15,000 to $30,000, particularly when you think in terms of family income, the effect of inflation, and the pyramiding of Federal, State, and local taxes.

I am sure you are all very sensitive to the fact that we now have an extraordinary impact on taxes from social security. Social security is a tax and it is a very severe tax and we have to face up to its burden. Some people in the lower brackets are paying more in social security than they are paying in Federal income tax.

In addition, you know what is going on at the State level, with respect to real estate taxes, part of which is due to inflation but also because of excessive State expenditures which have joined the Federal Government in excessive expenditures. Then the counties and the cities take their toll and we see, for example, in the State of Maryland, the so-called piggyback technique where you pay a flat income tax for State purposes and then each county adds 50 percent or more against its residents. The latest proposal from some in Montgomery County is a 65 percent piggyback. I recently received a gas bill which had a county surcharge of $24. This is going on at a rate affecting the area of middle-income tax brackets which I consider to be approaching a

crisis. We have to do something about it. Otherwise, in a real sense, I think we are going to have a tax revolt in this country. I am also aware that the basic problem is terribly excessive Government spending, Government inefficiency, and ever-growing Government programs.

In connection with the impact of foreign earnings taxation, I won't go into our technical recommendations which are spelled out in our statement. Time does not permit. I have already indicated to you by the figures cited that those who advocate further punishing of foreign earnings fail to recognize the benefits to the United States and U.S. industry as documented in the prefatory part of my remarks. In less than 3 years—2 years and three quarters—U.S. companies earning abroad have repatriated $40 billion which has been subjected to U.S. tax and the balance available for domestic investment, creation of new jobs, payment of dividends, conduct of research and development, et cetera. Companies which operate internationally operate as totally integrated organizations, and their total operations benefit the United States greatly and American industry.

We recommend strongly against any further restrictions on the DISC provisions in the code. We favor removal of double taxation of dividends. We oppose strongly any negative tampering with the ADR depreciation system with the understanding that it might be liberalized.

I think that within the time limits, that is about all I can cover, except to refer you to the summary of our main statement and its full text.

Senator BYRD. Thank you.

Senator PACKWOOD. No questions.

Senator BYRD. Senator Curtis.

Senator CURTIS. You suggested that a taxpayers' revolt might occur. What happens then?

Mr. STEWART. I recently came back from Williamsburg where I watched that wonderful movie which covered the stamp tax and the attitude and action it produced. I think in this case the attitude will show in the ballot boxes. I mentioned especially the people in the $15,000 to $30,000 brackets. I think they will express their views in that manner.

As you go back home and I travel out into the field, I observe that people are becoming so frustrated. Fortunately, inflation is abating a little, but when you add this pyramiding of taxes to the other problems which confront people in that category—and I do not demean the problem of the real poor—but a man can get pretty poor pretty fast even if he is making $25,000 a year if he has a large family and is trying to put someone through college, trying to pay his bills, et cetera.

In addition "revolt" is not a proper word. We have already seen the impact of excessive taxation, because these families have had to cut back on their purchases of what might be called big ticket consumer items, such as automobiles, refrigerators, vacations, et cetera. During the depth of the recession, their reaction if not their revolt was expressed in curtailment of expenditures which helped create the worst recession we have had in many, many years.

Senator CURTIS. I am not challenging you at all. I share your concern. I think one of the great problems is that people do not understand where the heavy expenditures are. Those who believe that just eliminating waste and trimming a little bit here and there will be sufficient to resolve our problems are simply misinformed. We have a current deficit of around $74 billion. The most optimistic estimate of eliminating waste might reduce the deficit by $22 billion, but we would have a $51 billion deficit, which is a tremendous amount.

It took us 185 years to reach a level of spending of $100 billion. It took only 9 years to go from $100 billion to $200 billion and then it took only 4 years for this geometric progression in spending to reach $300 billion.

Now, our real problem is that the welfare state is here. It has been voted in bit by bit over the last several decades. Out of every dollar spent in Washington, 40 cents in benefits goes directly to individuals. Another 15 cents goes in grants to States and local cities. The States pass on 5 cents to individuals so individuals are getting 45 cents. Thus States and localities and individuals together receive 55 cents out of the dollar.

The interest on the national debt is another 8 cents. That is 63 cents. We are currently spending about 26 cents for national defense and we are starving the national defense budget.

Two years ago, we were spending 28 cents for defense and, 10 years ago, it was 40 cents, but the 26 cents we are currently spending on defense makes a total of 89 cents and all other functions of Government cost 11 cents. It does not cost so much to govern. It costs a lot to provide. These programs were not instigated because the people demanded them. They were election schemes of candidates for office and candidates for reelection promising this and that and they are all cumulative.

The Senate will soon debate a bill on the food stamps. When this program started out in 1964 it was a $30 million program. This year, it costs $6 billion. A little cosmetic trimming won't amount to anything. I will have a series of 19 amendments that will cut off $2 billion of that. Many lose sight of the fact that this program is only a nutrition program. It is not an income supplement.

The same people who will be eligible for food stamps, probably are drawing AFDC or some other benefits. They become eligible for rent subsidies and that makes them eligible for free medicine.

I am not trying to detract from your splendid paper on taxation to give you a lecture about this, but the point is that the American people will have to become better informed on these problems or the Congress will never cut back and eliminate some of the spending programs. The mood of the Congress is not to face the realities of the costs of social security but to pay for it out of general revenues. That means adding to the deficit. It is very deceptive, but we are going to have to have something more than just pounding the table and saying we are going to cut appropriations. We have too many programs to appropriate for.

That is all, Mr. Chairman.

Senator BYRD. Senator Hansen.

Senator HANSEN. I came after Senator Packwood.

Senator PACKWOOD. I have no questions.

Senator HANSEN. I have no questions, but Senator Fannin, who had to leave to attend another meeting, has four questions that he would like to submit to Mr. Stewart. I will read all of them. If you would like to respond individually for such time as you might have, you do so.

First, why do you feel so strong about a high level and permanent investment tax credit?

Two, your statement expresses serious concern about certain restrictive changes already made in the provisions of the Internal Revenue Code affecting taxation of foreign earnings by U.S. subsidiaries or affiliates abroad and brought about additional proposals under consideration, not so much in technical terms but broad policy objectives. Would you spell out your position and refer to DISC if you wish?

Three, I was interested in your comments on tax reduction for individuals. Would you please comment further on the views you have expressed in this connection?

Four, would you amplify your views regarding tax treatment of so-called noneconomical expenditures for the purchase and installation of facilities and equipment required under antipollution safety and similar statutes?

Within the time that you have, would you answer and if you run out of time, perhaps your responses could be included in the record to be given at a later time?

Mr. STEWART. I think I can do it crisply. Perhaps that is a better way to communicate under most circumstances anyway.

A high-level and permanent investment tax credit is desirable because it is simple, it is productive in terms of incentive for capital investment which is essential to capital formation and to an improvement in productivity. It has proved itself. It benefits a much wider range of organizations than is generally thought. For example, the farmer is a beneficiary of the investment tax credit. The retail establishment with automated equipment that moves packages and goods is a beneficiary. Most people think in terms of the credit as being of value only to manufacturing establishments. This is wrong.

As to my concern about certain restrictive changes already made in the provisions of the Internal Revenue Code and what might be ahead regarding foreign source income, I have already made the central point and remade it, mainly that these foreign investments which produce foreign earnings are very beneficial to the domestic economy and are being repatriated at a much more rapid rate than is realized—$40 billion in less than 3 years.

Further, we cannot shut our borders in terms of international policy of the United States. We have to recognize that markets are where they are. Some markets cannot be penetrated by export from the United States. We do need viable foreign affiliates and foreign subsidiaries in order to make our total business structure in this United States internationally competitive and strong.

I don't believe I need say much more about how strongly I feel regarding the individual personal tax structure. My principal purpose was to try to get more concentration on what some people might think is a fairly high band of income; namely, $15,000 to $30,000, but when

you factor in the items I have mentioned, you can very soon be in a loss position, even at that rate of income.

I really appear here more as a citizen in calling attention to this issue because my constituency is not the personal income tax sector of the United States.

Finally, I have stressed that these expenditures for installations and facilities and equipment required for antipollution, safety, and other similar statutes, involve a diversion of approximately 10 to 12 percent of otherwise available funds for productive investment which mean more jobs and better productivity, and so on. I feel very strongly that these programs should be carried forward. They should be perhaps intensified, but we do need the capital formation to support them. We made a bad effort in terms of tax policy with the so-called special amortization provisions, and I think we ought to go back to the drawing board and do it again and do it right.

Senator HANSEN. You might be interested to know that a 1975 study showed that, for a recent 6-year period, taxes at all levels of the Government represented the single largest increase in the cost of living for the average American family.

I thought that could be of some interest to you. It underscores the urgency and the concern that is reflected in your statement.

Thank you, Mr. Chairman.

Senator BYRD. I am glad to see your strong emphasis on the heavy tax bite which government is taking from the people of this Nation. I am particularly interested in your views as to how the middle-income taxpayers are being hit and hit very hard.

I think Senator Curtis, in his comments, put in focus the fact that the tax problem goes back to the spending problem. The only purpose of taxes is to take care of government spending. The politicians in Washington have a very good thing going for them. The Congress is increasing spending by $50 billion a year, and simultaneously, it is decreasing taxes by $25 billion, saying in effect, don't worry about the spending, no one has to pay for it, we are going to reduce your taxes. All that needs to be done is add it to the debt and nobody has to pay for it. That is a pretty good political position to be in, but I think the public is beginning to see through that program. I cite that because recently I got a petition from the employees of the General Electric plant at Portsmouth, Va. It is actually in the city of Suffolk. There are 3,000 employees in that plant. Their representatives brought to me a petition signed by 2,588 employees. It said this, "We urge the Congress to reduce taxes, reduce interest rates, and reduce excessive Government spending."

Now, these people realize that a reduction in excessive Government spending must accompany any effort to reduce taxes or to reduce interest rates. Otherwise, you get a phony reduction. You might get a reduction in direct taxes but you get an increase in the indirect tax in taxation. Until we get spending under control, it is not likely much can be done about taxes. I think that the taxpayer revolt that you mentioned may be the only way that this country can get back on a sound basis and get spending under control.

It was refreshing to hear your testimony here this morning.

Senator Dole.

Senator DOLE. I have no questions. I arrived when Senator Curtis was talking about the food stamp hearing. I just left a hearing on another nutrition program which started off from zero in 1973 and it is up to $250 million a year. It is called the WIC program. If projections are accurate, it will be $1 billion in just one program. I am going to the Budget Committee now to see where we can save the taxpayers. I think your comments have been refreshing. I think sometimes we have the wrong people in the pews. The people who want to hear these messages are not here. They are out figuring ways to spend money. It is a good year, particularly if you are a Republican.

Mr. STEWART. I think the message we have been discussing can be sent in a number of ways. It is a message that is building up and we will see that message delivered. I think, also that those of you who have had a chance to read that very long statement of ours, at several points we indicated that we believe certain things might be done if revenues permit. I think it is a bit irresponsible to come before any congressional body and say we need the following things on behalf of business—1, 2, 3, 4, 5, 6—and not recognize what is now popularly called tax expenditures which would be involved. I think, also, those who feel as I do and who I believe are beginning to speak out as in the case of the petition to Senator Byrd, have to recognize that as individuals, we are going to be obliged to lower our sights somewhat in this country to get things squared away. It is not all the Government's fault.

I read an article in a local paper the other day saying that a mother and father were both in school, they had three children, and they were qualified for food stamps. I don't happen to believe that the U.S. Government ought to guarantee the ability of individuals to go to college and feed their families by food stamps paid for by the taxpayer. College may not be the panacea, as some of us are finding out, in terms of observing it as it fails to produce people who can earn a living, particularly in a tight economic situation. So, I agree completely with one of the implications of the comments about cutting back. Government is in a runaway position in spending, but it is not all government's fault.

We have to realize that the sights of individuals and families have got to be lowered to some extent, and we know from the recent—I trust it is recent and will not recur—serious recession that many people did reasonably well under much restrained conditions by cutting back, by lowering their sights.

So, I concur completely in the remarks you made about the responsibility of Government but at the same time, there is not a complete absence of pressures from individuals and from the private sector as well.

Senator DOLE. How do you answer the charge when they say when you give it to a business, that is a subsidy, but when you give it to a poor person, it is welfare?

Mr. STEWART. Once again, we are dealing with words.

Senator DOLE. Don't spend much time on it because I have not been able to answer it either.

Senator BYRD. Thank you very much.

Mr. STEWART. We appreciate the opportunity. We will leave these studies for the committee and staff.

Thank you.

[The prepared statement of Mr. Stewart and a MAPI statement entitled "The Favorable Impact of Direct Investment Abroad on the U.S. Balance of Payments: Spending More To Get More," follows. Oral testimony continues on p. 1291.]

STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE PRESENTED BY CHARLES W. STEWART, PRESIDENT

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Our national economic policies at this time should include substantial tax reductions, spending restraints to the extent necessary, and a reasonably accommodative monetary policy. These policies would increase private savings and investment and minimize inflation.

CAPITAL FORMATION (PAGE 2)

Capital is a key factor in attaining U.S. economic goals and our capital requirements are rising rapidly. However, business savings in this country are on the decline as a portion of total savings, and this country is lagging behind others in investment and productivity growth. A significant part of the problem is our income tax system which is heavily biased against savings and investment.

MAPI recommends:

1. The Senate should at least approve the House-passed extension through 1980 of the current 10 percent investment tax credit. Our longstanding position is that the credit should be increased to 12 percent on a permanent basis. (Page 12.)
2. For the longer run, capital cost recovery systems divorced from useful lives also deserve careful study by Congress. (Page 13.)
3. The reasons in favor of eliminating the existing double taxation of dividends are compelling, and the reform would help increase capital formation. (Page 14.)
4. Relief is needed now for taxpayers with basically nonproductive capital spending required by law with respect to the general and working environments. A 15 or 20 percent investment tax credit could be provided for this equipment. Alternatively, Congress could enact a new and expanded rapid amortization provision. (Page 15.)
5. Reductions in the 48 percent corporate income tax rate should be undertaken when resources permit. (Page 16.)
6. Tax reductions for individuals are another priority matter, and should be made available across-the-board or at least high enough into the middle-income brackets to ease the confiscatory situation which now exists. (Page 18.)
7. Something must be done about the inflationary bias of the existing system against most taxpayers, and indexation is one remedy to consider. (Page 19.)
8. The House-passed proposals with respect to tax shelters and the minimum tax on tax preferences constitute indirect and procedurally inappropriate attacks on desirable incentives to capital formation. (Pages 21 and 23.)

TAXATION OF INCOME FROM ABROAD (PAGE 25)

Capital formation is affected by taxation of income from abroad as well as that from home. Further, in taxing income from abroad, it is important that this country not place U.S. companies at a disadvantage to their foreign competitors.

MAPI recommends:

1. The Domestic International Sales Corporation provisions of our tax law should be left unchanged. Better still, the abatement of tax disincentives they provide to taxpayers engaged in export activity should be increased. (Page 26.)
2. Congress should not impose current taxation on undistributed earnings of foreign subsidiaries, but should think instead in terms of eliminating Code subpart F. If subpart F is kept, Congress should reenact the minimum distribution exception and make certain other changes. (Page 29.)

The proposals in regard to a "50-50 split," foreign tax haven manufacturing corporations, and "runaway plants" are unduly complicated and have serious conceptual deficiencies.

3. Congress should preserve the "per country" limitation on the foreign tax credit intact; should scuttle the proposal to "recapture" losses under the

"overall" limitation; and should drop the capital gains revisions aimed at the overall limitation. (Page 34.)

4. The exclusion for income earned abroad should be retained to compensate for inadequacies of the foreign tax credit. (Page 38.)

5. The tax laws dealing with Western Hemisphere Trade Corporations still benefit this counrty, and the reasons given for eliminating them are not persuasive. (Page 41.)

OTHER CORPORATE AND INDIVIDUAL INCOME TAX ISSUES

MAPI recommends:

1. Qualified stock options are effective productivity incentives, and the current tax treatment should be left intact. (Page 44)

2. The moving expense revisions approved by the House are better than none, but there should be higher limitations and more types of deductible expenses because these amounts are not in the nature of compensation. (Page 45.)

3. The House-passed changes dealing with advance rulings for certain transfers involving foregin corporations abroad appear, generally speaking, to be beneficial. (Page 46.)

4. A stronger statutory base is needed by IRS to manage public access to private letter rulings. We support some of the proposed changes but believe that all taxpayer identification should be removed from rulings made available for public inspection. (Page 48.)

The Machinery and Allied Products Institute (MAPI) appreciates this opportunity to present its views to the Senate Finance Committee on possible revision of the U.S. federal income tax laws. The Institute is the national organization of capital goods and allied equipment manufacturers and also includes in its membership a range of major equipment users. It has long engaged in an extensive program of economic and tax research with much of that research directed to questions of capital formation. A number of these studies are referred to in the text of this statement and, in addition, they are listed as an appendix to our presentation. Not infrequently, this research has considered the impacts of federal income tax policies, and changes in the same which could facilitate or interfere with the achievement of national economic goals. Accordingly, it is with considerable interest and concern that we participate in the current dialogue on tax revision.

Our statement is divided for convenient reference into several parts, although most of our comments on different topics under investigation have a common theme. This theme is capital formation. An adequate level of capital formation is a prerequisite to the achievement of basic goals of our economy, such as faster growth, less unemployment, increased productivity, lower rates of inflation, and an improved standard of living. Accordingly, our statement begins with that subject, including a look at the state of affairs with respect to capital formation and a review of selected tax legislative proposals specifically intended to alter the existing disincentives of taxation to savings and investment.

From capital formation directly considered, we proceed to other tax revision subjects which affect income and savings and, hence, the ability or disposition of individuals and corporations to invest. For ease of reference, these matters are dealt with under the headings, "Taxation of Income From Abroad" and "Other Corporate and Individual Tax Issues."

Before proceeding further, we should summarize our thoughts about federal fiscal and monetary policy generally, at this time, in helping to keep the U.S. economy on an even keel as it recovers from the deepest of post-war recessions. Briefly, we disagree with those who advocate highly stimulative fiscal and monetary policies at once as a sort of "quick fix." This would surely lead to higher rates of inflation and soon stifle the recovery. In our opinion, the appropriate course now is one of removal of disincentives in our tax system and a reasonably accommodative monetary policy, coupled with restraint of federal spending to the extent necessary. This would result in a minimum of inflation and provide the necessary incentives to investment. In this connection, we do acknowledge that federal revenue considerations must be carefully weighed.

CAPITAL FORMATION

As the Committee knows, capital is a key factor in attaining the economic goals toward which this and most other societies strive—namely, faster economic growth, less unemployment, lower rates of inflation, and an improved standard

of living. Moreover, if capital is available in sufficient amounts at costs that are reasonable, we can depend generally on the risks and rewards of our market system to lead to efficient allocation and steadily improved uses of that capital.

If one accepts that these economic goals are desirable and that capital is a key factor in our advancing toward them, then the question arises as to what are adequate levels of capital formation in our society. Because of recent high levels of inflation and unemployment, shortages of goods, and declining real incomes, this question has received attention as never before. In part, this attention has focused on domestic trends with respect to capital formation. Also, because the answer to the question "how much" in this context is partly a relative one due to international trade and related considerations, much study has been directed to the performance of the U.S. economy in capital formation as compared to that of other industrial countries.

Domestic capital formation

The findings of most of these investigations, whether conducted by government or within the private sector, are largely in agreement about present conditions of capital formation in this country, including the outlook, and the situation is not encouraging. For example, regarding conditions in this country alone, Treasury Department studies[1] indicate that there continues to be a fairly steady level of total private savings as a percentage of Gross National Product (GNP). However, gross business savings have, since 1965, been declining as a proportion of gross private savings and as a percentage of Gross National Product. Moreover, when adjustment for inflation is made to the capital consumption allowance component of gross business savings, it becomes clear that an increasingly smaller portion of business savings has been available to provide for net additions to and modernization of domestic productive capacity.

MAPI has found that corporate profits have been substantially overstated in recent years because of the failure of financial statements and national income accounts to reflect the impacts of inflation. Indeed, for 1974, the Institute has determined that undistributed profits of nonfinancial corporations, adjusted to a current valuation basis for inventories and depreciation, was a *negative* amount In other words, there was not enough capital cost recovery to replace existing capacity, and nothing in the way of real undistributed corporate profits to finance investment in additional new capacity. This finding has been independently documented in a series of studies[2] by George Terborgh, Economic Consultant to MAPI and its former Research Director. The conclusion of one of these studies[3] is as follows:

We submit that the present situation is bad not only for business, but for the nation as a whole. Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is vital that they be large enough not only to motivate the expansion of productive investment, but to finance a substantial part thereof. It is frightening from a public-policy standpoint that the reinvestment of corporate earnings, realistically measured, has virtually ceased.

Whether there will be a "capital shortage" over the next decade depends, of course, on a variety of factors: the magnitude of the new demands for capital, the absorption of funds by the federal government, the volume of personal savings, etc., but certainly a major determinant will be the extent to which the corporate system manages to restore its saving capacity. With a shortfall of $40 billion last year relative to pre-inflation norms, it is evident that the reduction of this capacity can have a decisive impact on the future saving-investment equation.

The total return (before tax) to capital (debt and equity) of nonfinancial corporations as a percent of GNP has experienced a downward drift since about 1950 which has been very steep since 1965. Also, since 1965 there has been a sharp increase in interest paid as a percent of total net return to capital for nonfinancial corporations, partly due to rising debt-equity ratios which leave business more vulnerable to cyclical downturns and inhibit new investment. This phenomenon

[1] As presented in the statement of Secretary of the Treasury William E. Simon to the House Committee on Ways and Means, July 8, 1975.

[2] "Inflation and Profits," MAPI Memorandum G-70 of January 1974, revised and republished in July and December 1974.

[3] "Corporate Savings and the Capital Shortage," MAPI *Capital Goods Review* No. 100, September 1975; see also a current study entitled "The Sad Story of Corporate Profits" by George Terborgh, March 1976.

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of debt-equity changes has been documented by MAPI in a study,[1] using Federal Reserve Board and Commerce Department figures, which reviews the sources of capital expansion financing by major categories for nonfinancial corporations during the years 1950–1974. The MAPI study concludes, in part, as follows:

It is to be hoped and expected that most corporations will show sufficient foresight in their financial planning to avoid further large increases in the relative importance of debt. Unfortunately, however, in the absence of appropriate action by the federal government to improve after-tax earnings—either through successful anti-inflation policies on the one hand and/or the enactment of additional and appropriate investment incentives on the other—the only alternative to further increases in corporate reliance on outside financing is a large reduction in the rate of expansion of U.S. production facilities. Such a reduction in corporate investment would in turn force a sharp cutback in U.S. social goals and programs and lead to a substantially reduced increase in U.S. living standards.

Chairman Arthur Burns of the Federal Reserve Board and Secretary of the Treasury William E. Simon, in public statements referred to in the MAPI commentary, have both expressed concern about the high level of debt carried by U.S. corporations and the degree to which this is dangerous in a number of respects, including substantial erosion of the financial flexibility of U.S. corporations.

Foreign comparisons

MAPI has published a study[2] which makes some relevant comparisons between the United States and Belgium, Canada, Denmark, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland, and the United Kingdom. For the period 1963–73, figures published by the Organization for Economic Cooperation and Development and by the U.S. Bureau of Labor Statistics, as reported in the MAPI study, show the following:

1. The United States had the lowest average annual percentage growth in real gross domestic product (GDP) per civilian employee and in output per manhour in manufacturing.

2. The United States, in comparison with Belgium, Canada, Japan, The Netherlands, Sweden, and the United Kingdom—data inadequacies preventing a comparison with the other five OECD countries mentioned earlier—had the lowest average ratio of fixed investment to GDP in manufacturing and the lowest average annual percentage growth in manufacturing productivity. MAPI's analysis of these performance figures for all seven countries shows a remarkably close correlation between investment and productivity.

This MAPI study goes on to note that, despite our comparatively poor showing in investment and productivity growth, the U.S. competitive position in world markets has been immensely improved in recent years. However, the improvement is attributable in a major degree to the much steeper rise in employee compensation in Europe and Japan than in this country, coupled with the U.S. dollar's devaluation relative to most European currencies and the Japanese yen since 1971. The study concludes, as follows:

This country cannot count on further major devaluations to maintain its competitive posture in world markets. Nor can it rely on further rapid increases in the earnings of workers abroad whose real earnings and living standards in some countries are already approaching those in the U.S. If the United States is to continue its position of political and economic leadership in the world and to maintain the world's highest living standards, an improvement in productivity performance is crucial.

While the evidence reviewed above does not *prove* that relative productivity performance is dependent to a significant extent on the relative level of fixed investment among major industrial countries, it *strongly supports* that proposition, thereby pointing to the need for an intensification of our efforts to expand and modernize U.S. industrial capacity. This is turn will require a high level of capital formation.

The outlook

Although forecasters have differed somewhat in their evaluations of the U.S. capital formation outlook for the near-term future, the mainstream of thinking—in which we concur—is that the demands for capital as a proportion of GNP

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[1] "Corporate Financing of Economic Growth: Some Questions About the Mix of Internal and External Financing," MAPI *Capital Goods Review* No. 101, October 1975.

[2] "Fixed Investment and Productivity Growth in Major Industrial Countries, 1960–1973," MAPI *Capital Goods Review* No. 102, February 1976.

will necessarily increase. For example, the Department of Commerce last year estimated[1] that capital requirements of the U.S. economy over the 12 years, 1974–1985, would total somewhere between $4 and $4.5 trillion. It will be recalled that the private sector of our economy spent roughly $2 trillion for these purposes (in constant 1973 dollars) during the preceding 12 years. Of this projected amount, plant and equipment investment would total about $3.5 trillion and residential housing would make up the balance. There are public and private organizations which have come up with similar figures on the demand side.

The reasons for the increase in capital demand projected by Commerce and others can be found in such things as the increased growth rate of our labor force; increasing economic competition worldwide; our aging stock of plant and equipment; inflated prices; and increased capital expenditures for energy, mass transportation, anti-pollution equipment, occupational safety and health, and raw materials. A MAPI study in 1973[2] spoke of the confluence of these elements affecting capital demand and stated that they argue for higher ratios of capital formation to national product than we had theretofore considered normal. The study concluded, as follows:

The moral is clear. If we are at all right in predicting higher levels of demand for plant and equipment, since the enlargement of business investment depends primarily on an increased flow of funds available for the purpose, there is a pressing need to assure that tax policy encourages private saving and capital formation. This is the surest way to achieve and maintain the higher rate of economic growth which is essential to our national well-being.

As the Committee is aware, Treasury concurs in the view that in order to meet our employment and growth objectives the demands for capital as a proportion of GNP must increase very substantially beyond what has been experienced in the past. Furthermore, to finance the shift in resource use toward more investment, it seems an agreed proposition that either more private savings or sharp reversals of government deficits will be required. Given the political process, we should not expect too much in terms of sharp reversals of government deficits through reduced spending although the objective, generally speaking, is an admirable one. Moreover, progress can be made in this area and the new budget process in the Congress is commendable. Also, we obviously would not suggest that the reversals be attempted by increased taxes which extract from taxpayers money they would have saved themselves. Consequently, in the current dialogue on tax revision, we should be mindful of what can be done to encourage and support more savings and investment or to reduce the existing disincentives to savings and investment in our tax laws.

As our comments to follow will indicate, nearly every tax law change under examination has a potential impact on capital formation, even though the connection in some cases is less direct than in others. As to those changes where the potential impact may not be readily apparent, we would note only that a dollar taken from a taxpayer in payment of a tax (or taken sooner) is a dollar no longer (or for a lesser period of time) subject to his decision whether to save or consume. The converse of this proposition also is true. While we would not suggest that this potential impact alone should be the "litmus test" by which Congress determines the desirability or nondesirability of all tax proposals, it is in fact a very important consideration in most of them and should be determinative in some.

Taxation and capital formation

As Treasury itself acknowledges, our income tax system is heavily biased against investments producing financial returns that constitute taxable income. Indeed, our system presents definite disincentives to private saving as compared with consumption by taxing away a substantial part of the returns to capital; in some cases, doing so more than once; and in some cases taxing the capital itself through assessments against "income" that exists only because of deficiencies in the Internal Revenue Code and the historical cost accounting model on which it depends. Further as to the last-mentioned point, the federal income tax is taking ever larger bites from the real incomes of most individuals and businesses and is becoming increasingly progressive and redistributive because of

[1] See the statements of Treasury Secretary Simon before the Senate Finance Committee on May 7, 1975, and Mar. 17, 1976.

[2] "Business Capital Formation—Putting It in Perspective (1925–1970)," MAPI *Capital Goods Review* No. 94, December 1973.

dollar-amount exclusions, exemptions, deduction limits, income brackets, etc., which are not responsive to inflation's impacts. In other words, for many taxpayers, there is proportionately less income to convert to private savings, even if that should seem desirable, because their taxes are rising even though their real incomes are not.

As if the federal income tax itself were not a sufficient discouragement to savings as compared to consumption, the problem is compounded by federal estate and gift taxes and state and local levies (substantial and varied in nature) which take their additional tolls from capital and returns to the same. Also, there are structural problems in the federal income tax which result in returns to equity capital being taxed differently than returns to debt capital, and this presents another impediment to capital formation.

As already suggested, we do not wish to leave the impression that we think taxation is all to blame for the relatively slow pace of investment in this country. Taxation is only a part of the problem. Nor should we think of changes in the Internal Revenue Code as a panacea. However, we are convinced of the need for an accelerated rate of private savings, and know that the tax laws could be altered to help achieve this objective. Furthermore, we believe that the savings and investment so induced would stimulate our economy and more than erase the temporary revenue losses associated with them. Put another way, we know of no surer means by which to cause real incomes to rise in the years ahead than to have a step-up in capital formation through accelerated private savings and investment.

We acknowledge that the temporary revenue losses could be sizable depending on what Congress chooses to do. Moreover, we know that there are competing and growing demands for federal dollars plus other meritorious pleas for tax relief, including some involving permanent revenue losses, before the Committee. Also, we concede that it is no easy task to determine the lead times for recapture of revenues temporarily lost, or even to know that recapture is happening with respect to a particular tax change.

On the other hand, the present state of capital formation in this country is unsatisfactory, with serious long-range implications for the U.S. economy, and the problem deserves attention now. For that reason, we urge the Committee to consider tax changes favorable to private savings as being a priority matter, and to move forward with a program as quickly as resources will permit.

Our comments on specific "capital formation" items follow.

Investment tax credit

We think that one of the most important single items before the Committee at this time to lessen existing tax disincentives to business savings is the investment tax credit. As we indicated to his Committee in connection with the Revenue and Expenditure Control Act of 1975, we feel that the Committee should at least go along with the House-passed extension through 1980 of the current 10 percent ITC. Our long-standing policy position is that the credit should be increased to 12 percent and be made permanent, as we testified before both tax-writing Committees in connection with the Tax Reduction Act of 1975. The credit is a "tried and true" mechanism for lessening the burden of income taxation on business investment. Also, it is relatively simple to use, is directly connected to investment in qualified property and benefits not only manufacturing companies but farmers, certain retail establishments, and other parts of our economy which use productive equipment. Furthermore, the investment tax credit clearly works as intended.

If structural changes are to be considered for the ITC, we suggest that attention be given to President Ford's proposal of October 1974 to make the credit refundable on some basis so that it can be used by taxpayers who have no tax liability due to losses but nonetheless must continue to invest in productive equipment. On the other hand, we strongly oppose the "basis adjustment" concept on which the President conditioned his support of the refundable credit proposal in 1974.

There is a further possible utilization of the investment tax credit that Congress, in our view, should consider now. Legislation which was enacted by the Congress to provide special amortization for pollution control equipment and certain other defined qualified expenditures expired as of December 31, 1975. As we discuss in more detail later, expenditures for anti-pollution equipment, equipment required under administration of the Occupational Safety and Health

Act and any mandated expenditures for capital equipment for other socio-economic reasons, should be provided the strongest possible tax incentive and tax support. The prior law was little more than useless because of the technical provisions in the statute and in the implementing regulations which were highly restrictive. A simple procedure by which these capital investments could be treated would be to make a 15 or 20 percent investment tax credit applicable to them.

Other capital cost recovery programs and proposals

In general, we support the Asset Depreciation Range (ADR) system of capital cost recovery. If changes are to be made in it, we suggest that they be in the direction of simplification and enhancement of the system's cost recovery attributes. To that end, it would be useful for the Committee to determine whether the ADR system is competitive with depreciation allowance programs of this country's major trading partners. It is our impression that an increasing number of industrialized countries are abandoning the "useful life" concept in order to simplify administration of this part of their tax laws and to allow cost recoveries which more nearly compensate for the inadequacies of historical cost accounting in an inflationary economy.

At least for the long run, we believe that some form of capital cost recovery divorced from useful lives deserves careful study by the Committee as a means for stimulating business savings and encouraging capital investment. Also, if it should appear that foreign fiscal systems have become substantially less burdensome to their taxpayers than is ours, in terms of overall investment allowances, then that would add weight to the case for liberalizing depreciation provisions now.

Before leaving this subject, we want to emphasize that a high level and permanent investment tax credit, and with ADR or some more liberal and simplified system relating to depreciation, are not alternatives. Contrary to Senator Kennedy's current proposals which would rescind ADR and maintain a permanent investment tax credit, we believe that both the investment tax credit and a modern and liberalized depreciation system constitute a two-part package which, at the minimum, should not be reduced or restricted in any way. Once again, we recognize that any further liberalization of our depreciation system must take into consideration federal tax revenues.

Double taxation of dividends

The principal new proposal of the Treasury Department to lighten the current tax burden on savings and investment is to eliminate the existing double taxation of distributed corporate income by what is technically called "integration." We agree that this should be done as soon as revenue and other circumstances will permit because the existing system of double taxation (1) is objectionable per se; (2) creates a bias toward debt financing and away from equity financing which tends to encourage debt-heavy capitalizations with more susceptibility to business downturns; (3) reduces the net returns to capital; and (4) has been eliminated from the income tax systems of a substantial number of our trading partners.

As we see it, the reasons in favor of this change are compelling and the reform would be conducive to increased capital formation. While it involves a significant reallocation of resources, the Treasury Department has determined that it can be accomplished on a phased basis and that it would be self-financing in that the revenue losses would be erased by feedback revenues.

Tax incentive for nonproductive capital expenditures

We urge that action be taken *now* to relieve taxpayers faced with basically nonproductive capital expenditures which are required by law. Our special concern here is with the spending needed to upgrade and protect the general and working environments under the Clean Air Act, the Federal Water Pollution Control Act, the Occupational Safety and Health Act, and similar federal laws. Available data from McGraw-Hill indicate that approximately 10 percent of total capital expenditures now flow to investment in environmental and safety equipment. This is a large and growing drain on the total pool of available capital, and, although spending for these purposes is considered worthwhile and necessary, it reduces the supply of capital for economically productive programs.

We have already stated our opinion that Congress should facilitate the financing by business of these mandated facilities. At that point in our statement, we

called to the attention of this Committee the possibility of granting a 15 or 20 percent investment tax credit for pollution control equipment, equipment installed as a result of the requirements of OSHA and its regulations and other similar provisions in the law.

Another approach would be to adopt a new and expanded rapid amortization provision modeled along the lines of Code section 169 which expired at year-end 1975. However, the cost recovery attributes of the provision should be such as to make it significantly more attractive than the existing alternative which is ADR depreciation plus the 10 percent ITC. Also, as previously suggested, the new provision should not be as encumbered as was its predecessor with limitations, restrictions, and multiple certification requirements. It is our impression that the Internal Revenue Service has taken a negative attitude toward continuation of a liberalized form of Code section 169, presumably on technical grounds that such a provision is difficult to administer and involves serious definitional problems. We submit that the first question that must be answered is whether it is in the national interest to give quite liberal tax treatment to the types of equipment under discussion. If the answer to that question is yes—and we believe it would be an unqualified yes—we urge the Congress to act and to build a legislative history which compels the Internal Revenue Service to interpret the law broadly and liberally. The Internal Revenue Service is constantly concerned with definitional problems and, over the years, has demonstrated an ability to solve them, at least to a reasonable extent. The definitional problems in this area are not insuperable and a mandate to IRS after enactment of an appropriate statute should make this clear.

It should be added at this point that we disagree with the "hard line" taken by the Treasury Department with respect to industrial development bond (IDB) financing of air and water pollution control facilities, and we urge the Committee to reject any proposed changes which would curtail the IDB provisions of Code section 103.

Corporate rate and rate-structure

President Ford has proposed to reduce the maximum corporate income tax rate from 48 to 46 percent and to extend permanently the surcharge exemption as restructed by the Tax Reduction Act of 1975 and extended temporarily by the Revenue Adjustment Act of 1975. These are thoroughly commendable reforms which should facilitate business savings and help with the capital formation problem. The surcharge exemption changes are justified if for no other reason than on the basis of inflation since the pre-1975 Act levels were enacted. However, we recognize that these proposals must be assigned a priority among other needed revisions in our federal tax system. Obviously, the President had priorities in mind, and it was his judgment that his proposed tax cuts should be matched dollar-for-dollar by curtailment of projected federal spending. However, it now appears that spending restraint of the order of magnitude envisioned by the President has not won congressional support.

Under these circumstances, and accepting the proposition that we ought not tax substantially less and spend substantially more at once if a "lid" is to be kept on inflation as the economy continues its recovery, then it is clear that choices will have to be made. The same conclusion follows from the realization that government does not necessarily facilitate business savings through deficit-widening revenue concessions if government must then draw down the total capital pool in financing its own operations. It therefore is essential in dealing with capital formation by means of tax measures at this time that we pursue those most likely to help. In this light, the ITC is unique in our opinion, and corporate rate reductions have an important but lower order of priority.[1]

Individual rate reductions

On the subject of rate reductions and priorities, if we may depart slightly from our capital formation theme, we are deeply concerned by the mounting burden of federal taxes of all types on middle-income working people. Earlier we referred to the impacts of inflation on our federal income tax. It is unfortunate,

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[1] By this statement, it is not our intent to demean an effective program for significant reduction in the corporate income tax over time. We are merely trying to be responsible in terms of priorities and effect on federal tax revenues. As a matter of fact, a MAPI study entitled *Effect of Corporate Income Tax on Investment*, published in 1959 but still current in substance and validity, documents the fact that high income tax rates have an adverse effect on investment and create an umbrella over obsolete equipment.

we think, that there is more thought given by some in Congress to accelerating the confiscation of middle-income citizens' earnings through adjustments to the tax laws than there is to stopping the trend. This is a sorry state of affairs, and the Ford Administration is to be commended for recognizing the case for relief across-the-board in the middle income brackets even though there has been little progress in that direction as a result.

Somewhere high on the list of priorities for tax relief, the Senate Finance Committee should reserve a space for "middle-income individuals," properly defined to include rather than exclude working families. The President has proposed, among other things, an increased personal exemption and a permanent reduction in tax rates for individuals. We urge favorable consideration of some such redress of the current situation, but only if it is not to be skewed by Congress out of the reach of middle-income taxpayers. If it is turned into a redistribution, the middle income group will again bear the brunt of it and we do not think that the Committee should support any such outcome. We note further that a "balanced" approach to rate reduction for individuals would generate some greater proportion of savings to consumption than would an approach which is basically redistributive. Thus, it would contribute in some measure to our capital formation objectives.

When we refer to middle-income individuals, it is our feeling that the government has not yet recognized the fact that many families with total incomes in the $15,000 to $30,000 range, when allowance is made for inflation and the many sources of tax attack on their incomes, they are in dire need of relief. The labor movement itself has begun to recognize that families and individuals in this general pre-tax income area are being subjected to punishing capital levies. They come from states, counties, and cities, as well as the more generally recognized federal levies. They take many forms, for example, social security at the federal level and county piggyback income taxes, county surcharges, etc. The total "take" is enormous and murderous. We submit that as a general proposition, anytime the United States Congress considers increased taxes affecting these so-called middle-income individuals, it should avoid tunnel vision by examining the total tax load borne by individuals in this country. Although we have just suggested that tax relief in this manner has a bearing on capital formation objectives, which is the central theme of this statement, those of us who are primarily representatives of business and members of Congress who must represent their total constituencies and the broad public interest are obliged to look harder at the vital issue of the rip-off of families and individuals in the income brackets referred to here.

Tax recognition of inflation

Earlier in this statement, we pointed out that business savings are very seriously on the decline, and that the inability of the federal income tax and the historical cost accounting on which it and taxpayers rely to allow for inflation's impacts are a part of the problem. We also observed that inflation has perverse effects on the taxation of individuals because of fixed-dollar exemptions, exclusions, deduction limits, etc. Rather than provide for a different type of accounting model or for adjustments to the historical one for tax purposes, tax relief to compensate for inflation—where provided—has heretofore been limited to devices which tend in one or another less comprehensive way to reduce the increasing burden which has befallen taxpayers. For example, depreciation lives have been adjusted downward and write-offs have been accelerated—although inflation has not been the only reason for those changes; last in, first out inventory accounting is permitted; and rates, rate brackets, deduction limits, exclusions, exemptions, etc., have from time to time been modified.

More recently, due to the pace of inflation, the accounting profession, regulatory bodies, and other concerned parties have taken more interest in the possibilities for dealing with this inadequacy of existing accounting through direct recognition and adjustment for inflation, the process being technically called indexation. Unfortunately, despite fairly broad agreement about goals generally, the dialogues have tended to founder on conceptual deficiencies of one approach versus another or on perceived problems of implementation that are more ominous in contemplation than they would be in actual practice. MAPI has taken part in this dialogue through the submission of views on "inflation accounting" proposals to the Financial Accounting Standards Board, the Securities and Exchange Commission, and the Cost Accounting Standards Board. The thrust of the Institute position is that accounting changes addressed to the problems and

impact of inflation are not enough. We strongly urge tax recognition; without it, the various accounting proposals that have been offered for comment by government and private institutions fail to go to the heart of the matter and merely accomplish a more accurate statement in real terms after inflation of financial results of corporations.

In recognition that the most serious consequence of historical-cost taxation is the erosion of real capital associated with it, the Institute has published a study[1] which proposes a system of index adjustments, for tax purposes, applicable to depreciation charges, inventory consumption costs, and long-term capital gains and losses. The program is a limited one that could be amplified later if the accounting profession and others were to reach a consensus on inflation accounting per books.

Clearly, a presentation to the Committee such as this one is not the place to explore the nuances of inflation accounting. It is a complex subject and questions of policy and detail should be examined at length by the tax-writing Committees in conjunction with the Treasury Department and with further input by interested parties. We raise the subject here and now to underscore our conviction that something *must* be done to insulate taxpayers and capital from the misapplication of federal income taxation due to inflation. Indexation is one approach to consider.

The minimum tax

One tax law revision proposal which comes up with disturbing regularity is a tightening of the minimum tax on "tax preferences," and we disagree with those who advocate more restrictions in this area. The minimum tax became law some six years ago as a consequence of public concern that a small number of taxpayers were not bearing their fair share of the fiscal burden. In fact, however, they were beneficiaries of tax provisions which Congress had previously defined as being in the public interest. Since enactment, the minimum tax has complicated the tax law and has contributed to the erosion of tax incentives which are important to savings and capital formation. While this has been going on, the minimum tax has attracted further interest among those who would like to reduce or eliminate existing "tax preferences" and bring other incentives within the scope of the minimum tax for the same purpose.

For a variety of reasons well known to this Committee—enlargement of industrial capacity over time to lessen inflationary pressures, the longer-range solutions to energy shortages, pollution control, mass transportation, to name only a few—we face unprecedented requirements for capital in the foreseeable future. Many so-called "tax preferences," such as accelerated depreciation and the lower income tax rate on capital gains, were consciously designed by Congress as desirable incentives for savings and capital formation. We believe the need for such incentives is now even greater than the undoubted need which existed at the time of their enactment. It is the possibility of a further indirect attack on such incentives via an extension of the minimum tax principle with which we are now concerned.

We urge that the Committee reject further expansion of the minimum tax concept. Indeed, we recommend its repeal. If there is some objection to "tax preferences," Congress should reevaluate them individually; consider the merits or demerits of each one which is in question, and do so on the public record; and then take direct action, if called for, in accordance with its findings.

"Tax shelters"

"Tax shelter" is a phrase which has acquired some unfortunate connotations in the public mind because of the work of some tax revisionists aimed at eliminating preferential tax treatment provided in the Internal Revenue Code for one or another kind of income or activity. In truth, most tax shelters are not dodges, and their use does not in any way constitute tax evasion, fraud, conniving, or lack of pariotism. In a broad sense, the process of usually one of investing in such a way as will produce deductibles timed to offset income which otherwise would be taxable. This activity is carried out within the framework of the tax laws, consistent with the will of Congress as thus far articulated.

The proposals for tax change being studied under the heading of "tax shelters" concern us because of the possibility of tax change being enacted which is at cross-purposes with national economic policy. In the preceding section, we have

[1] "Inflation and the Taxation of Business Income," by George Terborgh, January 1976.

addressed the minimum tax on tax preferences and pointed out that Congress through that device is eroding tax incentives by indirection. The new proposal under scrutiny in this area is the limitation on artificial accounting losses (LAL), and it is vulnerable to the same criticism. The minimum tax and the LAL have an undesirable potential for permitting Congress to modify its stance on an issue without addressing it forthrightly. In our opinion, if Congress determines that farming activity or mineral extraction activity—to take examples at random—ought to carry a lighter tax burden than other activities, then Congress should not later vary the incentive without returning to the basic issues and reconsidering them on the record.

Accordingly, we urge the Committee to reconsider what it is that LAL would do to investment in various activities covered by the device and to be guided by that consideration rather than inflammatory rhetoric about "tax shelters." Also, we trust that the Committee will consider whether or not the timing of proposed tax changes under study is or is not propitious. We were struck by the incredibly short-sighted timing of congressional action last spring on percentage depletion for oil and gas, and we see no sense whatever—to take one example—in further punitive tax actions aimed at that industry. Closer attention must be given to national priorities as the tax reform dialogue progresses.

Other "capital formation" items

Many other subjects more or less directly identified with capital formation have been placed before the Committee for review. We have in mind such proposals as (1) H.R. 10612's increase in the amount of ordinary income against which capital loss may be offset, which we approve; (2) H.R. 10612's increase in the holding period for long-term gains or losses, the reasoning for which in House Report No. 94–658 is hardly persuasive; (3) H.R. 10612's tax-free rollover of certain distributions in the case of retirement plan terminations, which in our judgment is the only even-handed way for our taxing system to deal with these situations; and (4) H.R. 10612's limited individual retirement accounts for certain active participants in qualified plans or Code section 403(b) annuities, which we believe to be appropriate.

Other proposals deserving of study by the Committee are (5) the proposal to eliminate withholding interest and dividends paid to foreign persons, strongly supported by the Treasury Department in testimony before the Senate Finance Subcommittee on International Finance and Resources, March 1, 1976; and (6) President Ford's proposed Broadened Stock Ownership Plan, although we would favor a simpler incentive to individual savings and one that would be available to all taxpayers.

A final note on capital formation

As a final note on tax subjects readily identified with capital formation, we should point out that we are unable here due to limitations of time and space to explore all of the possibilities for tax relief. Our main purpose has been to indicate the direction in which MAPI's economic research and tax study has shown us the country should go and to express our thoughts about some tax law changes which could propel us along that way. Although we do have preferences in this subject area, including a very positive stance with respect to the ITC, we do not wish to seem doctrinaire about ways and means. Our message, in brief, is that the rate of capital formation in this country is woefully deficient; that tax disincentives to private savings are a large part of the problem; and that the situation needs prompt and bold attention and action.

Our views on other tax revision subjects follow.

TAXATION OF INCOME FROM ABROAD

U.S. taxation of income from abroad is not unrelated to capital formation even though the connection may not be apparent to those unfamiliar with companies which are worldwide in operation. To describe the characteristics of such companies briefly, they operate on an integrated basis and government policy should consider them as such. Income from abroad is not only important in maintaining and expanding where appropriate the economic commercial position of U.S. industry outside of our borders but, as is frequently overlooked, the financial results of foreign units of U.S. companies redound to the benefit of the corporation as a whole, including U.S. domestic operations. The performance of foreign units strengthens research and development in the total company;

they benefit U.S. exports; they create and maintain jobs in the United States; and in many other ways are vital to the health of American industry. The naive notion that foreign investment by U.S. industry and income derived therefrom should be treated as an enemy should be discarded in our national planning and public policy action.

As noted earlier, a dollar taken for taxation is one over which the taxpayer no longer has a choice whether to save or consume. This also applies to income from abroad. MAPI is concerned by the persistent efforts of some tax revisionists advocating tax changes adverse to export and foreign-source income because these changes could jeopardize the operations of U.S. companies and their foreign subsidiaries in international markets.

DISC

MAPI opposes repeal of the Domestic International Sales Corporation (DISC) provisions of our tax law. Also, we disagree with the approach of H.R. 10612 in making the DISC mechanism incremental. Changes such as these—only 3½ years after DISC came into being—would impact hardest those companies which have been doing most to help the U.S. export effort. Also, these revisions would tend to reinstate the trade problems which gave rise to DISC before U.S. trade negotiators in the "Tokyo Round" of multilateral talks have had a chance to deal with the question of export incentive practices of other signatories to the General Agreement on Tariffs and Trade. Not the least reason for keeping DISC intact is that it works as intended and this country has been favored by significant export growth and increases in related domestic employment since enactment, notwithstanding that there have been other factors contributing to this growth.

Treasury officials have indicated[1] that the direct DISC-related employment stimulus is on the order of 300,000 additional jobs. Also, Treasury has indicated that DISC repeal would increase our present problem of capital formation by rasing the taxes on capital at a time when they should be lowered. We concur in this view and would add that the provisions of H.R. 10612 only differ in that they are less thoroughly objectionable than repeal. As to the base-period technique, it reduces DISC effectiveness and complicates its use. We doubt that our foreign competitors have to deal with such "refinements" in their national export programs. Certainly, value-added-tax rebates for exported goods are not conditioned on an increase from base years.

As to the exclusion of munitions-list items from any DISC benefits, we find the explanation in House Report No. 94-658 to be unpersuasive. Price *is* a factor in the procurement of most munitions, and we do have a national interest in being a supplier of munitions-list items to our allies. The Committee might well ascertain from Treasury or another appropriate source whether foreign countries have excepted their defense industries from the export tax incentives made available to other taxpayers. On an administrative point, it should be noted that the munitions list consists of categories of equipment. It will be a problem for taxpayers and government alike to determine whether some items are covered in the list and whether they are intended for military use.

We do not think that the Committee is at all disposed toward DISC repeal; however, if that should come about we think it important in fairness to business taxpayers who established DISCs to provide for permanet forgiveness of the taxes deferred because of the understanding of many DISC owners that the taxes were deferred for a very extended period of time or indefinitely.

Finally, a few observations are in order regarding the history of DISC. When DISC was first conceived within the Treasury Department, it was intended to accomplish two objectives: (1) to improve the export position of U.S. companies in international competition, thereby make some move in the direction of "catching up" with foreign country programs directly supporting exports and, from a national viewpoint, improve our balance of payments; (2) to support jobs in the United States related to exports and to help facilitate the creation of new jobs related to exports. The Treasury submitted a DISC proposal which was simpler in structure and more liberal in thrust than the final DISC provisions enacted by the Congress. Treasury and the Internal Revenue Service then took a period of years in proposing DISC regulations. This in part resulted in a delay in testing and utilizing the DISC system. However, industry for the last year or 18 months has been in a position to demonstrate the very favorable effects of DISC on U.S.

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[1] Remarks of Treasury Assistant Secretary (Tax Policy) Charles M. Walker before the National Foreign Trade Council, Nov. 18, 1975.

jobs, on the position of U.S. exporters in international markets, and the total strength of U.S. companies interested in foreign trade.

It is against this background that any reexamination of DISC, beyond action already taken, should be focused.

Taxation of undistributed earnings of foreign subsidiaries; subpart F; and related matters

Of all the tax revision issues perennially studied by Congress, current U.S. taxation of undistributed earnings of controlled foreign corporations (CFCs) seems the item most doggedly pursued by persons interested in radical change. As the Finance Committee undoubtedly is aware, most other nations do not engage in the extraterritorial extension of their taxing jurisdiction which is involved in such taxation. Subpart F caused no little consternation in this matter of overreaching when it was put into effect, and one might think that current taxation not even linked to so-called tax haven situations would be considered a rather serious infringement of other nations' sovereignty.

Jurisdiction aside, there are other reasons for opposition to this shopworn tax revision proposal. For one, government estimates suggest that the *overall* U.S. revenue increase from current taxation of unremitted CFC income would be relatively small. This does not mean that the impact on individual companies would be insignificant. Indeed, for many companies it would be very substantial. It should also be borne in mind that current taxation of foreign earnings would have an unfavorable effect on U.S. economic activity. Further, one of the reasons that the overall U.S. revenue increase would be relatively small is that adoption of current taxation of foreign earnings would be an open invitation for foreign governments to place increased levies on earnings of U.S. affiliates or subsidiaries in foreign countries.

Further, U.S. based companies doing business through CFCs abroad would be immediately handicapped in competition with foreign-based companies if current taxation were instituted. It is reasonable to expect that the added tax expense would lead to declining market shares abroad for U.S.-owned companies; slower growth; less foreign income for CFCs to reinvest, or to distribute to U.S. parents; less U.S. business activity and employment from exports to CFCs; less U.S. tax revenues in the long run; a worsened balance-of-payments position; and a decline in the value of securities of U.S. businesses with such adversely affected foreign operations.

With respect to repatriated earnings of U.S. foreign affiliates, in the period beginning in 1973 through the third quarter of 1975. U.S. income from direct investment abroad was approximately $40 billion. This was two and one-half times the outflow. Note also that this $40 billion was subject to U.S. income tax, and the after-tax amount was available for domestic corporate use.

It is erroneously thought by some persons that if Congress were to make it difficult, tax-wide, to operate a business abroad, then the U.S.-based parent enterprise would transfer the business back to the United States, thereby increasing U.S. employment. However, it does not follow that foreign investment made uneconomic by U.S. fiscal activity will flow back to this country, particularly where cost and marketing considerations already prohibit use of a U.S. base for all or part of the activity. Increasing the burden of using the foreign base will not alter these considerations, and it may expel the U.S.-owned participant from the foreign market. Further, it is generally true that the U.S. export activity of a company is enhanced by having a foreign manufacturing and/or marketing infrastructure within which to operate. Many countries prefer to have these operations organized under their local laws, and, to the extent that the cost of maintaining this infrastructure prohibitive, there is likely to be an adverse impact on export activity.

There also are administrative reasons for opposing current taxation of unremitted foreign subsidiary earnings. As Treasury has explained, there are problems associated with modifying the U.S. tax liability of foreign corporations with minority interests. Also, there is the matter of securing the distribution of profits by such companies in order for the U.S. tax to be paid. Beyond these considerations, IRS would have to add thousands of foreign corporations to its audit list.

In short, on this issue Congress could (1) take restrictive action adverse to U.S. employment, dividend flows, etc.; (2) do nothing; or (3) take actions aimed at reducing tax disincentives to U.S. business activity abroad, thereby

boosting related domestic activity, including employment. In the last of these categories, the Committee should, we think, reconsider and then roll back last spring's repeal of the minimum distribution exception to subpart F. A bolder move, which would eliminate the worst briar patch in the Internal Revenue Code and Income Tax Regulations while harmonizing U.S. tax law with most revenue codes elsewhere in one respect, would be to eliminate subpart F itself.

Investments by CFOs in U.S. property.—If subpart F is not eliminated, H.R. 10612 contains a desirable refinement to liberalize the provision which now treats an acquisition of U.S. property by a U.S.-controlled foreign corporation as a taxable distribution to its U.S. shareholders.

Within the framework of subpart F, we agree with this change because it would eliminate a current impediment to a CFC's investment in this country. Investment flows thus induced would help this country to deal with its capital formation problem. In that connection, one wonders whether repeal of subpart F might not be a more worthwhile step toward this end. As matters stand, with the recent repeal of the minimum distribution exception to subpart F, there are situations in which U.S.-based business enterprises will now be at a relative disadvantage to their foreign-based competitors.

The "50–50 split"; FTHMOs; and "runaway plants".—We would be remiss if we did not comment on Congressman Ullman's proposal that one-half of the income of each CFC be required to be included in income on an annual basis, and on the proposals occasionally presented with respect to "foreign tax haven manufacturing companies" (FTHMC) and "runaway plants." In our opinion, the only merit of the Congressman's proposal is that it would be less *unsatisfactory* than current taxation generally. With due respect to the proposal by the very able Chairman of the Ways and Means Committee, it is an oversimplified effort to compromise down the middle road without addressing the merits of the issue. The 50–50 split would continue the creep toward current taxation, and, in doing so, would further complicate areas of the Internal Revenue Code and Income Tax Regulations that already are forbidding in their complexity.

As to FTHMCs and "runaway plants," these proposals were first aired, by the Nixon Administration, in April 1973. More recently, the incumbent Administration in November 1975 publicly gave notice that it had not abandoned the 1973 proposals even though they "may be too much at this time." In our opinion, both of these proposals for limited application of current taxation have *serious* conceptual deficiencies. If the FTHMC and "runaway plant" proposals are resurrected in the current tax revision dialogue, we would hope that the Finance Committee will review with care the extensive record compiled by the Ways and Means Committee in the spring of 1973 with respect to them.

Repeal of the minimum distribution provision.—As the Committee will recall, Congress repealed the minimum distribution provision of subpart F as part of the Tax Reduction Act of 1975. The misfortune associated, for many companies, with the repeal of this provision was compounded by the fact that Congress failed to include a change in the definition of "foreign base company sales income" which had been approved by the Ways and Means Committee in 1974 as part of its proposed subpart F revisions including minimum distribution repeal. Specifically, the Ways and Means' proposal had been to eliminate sales income on foreign manufactured goods from the definition of "foreign base company sales income" where the goods were sold for use, consumption, or disposition outside of the United States.

If the Committee does not reverse the repeal of the minimum distribution exception, we urge favorable consideration now of the change just described and suggest that it be given an effective date corresponding to that of minimum distribution repeal.

Foreign tax credit

H.R. 10612 contains proposals to alter the foreign tax credit (FTC) by (1) eliminating the "per country" limitation; (2) providing for recapture of certain losses under the "overall" limitation; and (3) inserting some new provisions dealing with capital gains and the overall limitation, involving "netting," rate equalization, and restraints on alleged artificial sourcing. We oppose these proposals.

Per country limitation.—Repeal of the per country limitation is partly a response to charges that this limitation sometimes can result in an amount of double benefit. Briefly, where a loss is incurred in a foreign country, it does not

reduce the credit for foreign taxes paid elsewhere. However, it does reduce worldwide taxable income on which the U.S. tax is based. Thereafter, when the loss operation becomes profitable (assuming it does) there is increased worldwide income but an FTC will be generated to offset some or all of the U.S. tax.

As to the grounds for partial repeal of the per country limitation earlier and complete repeal now, we think that there is an inconsistency. In the case of a foreign loss, if the federal income tax is to be based upon the worldwide income of a domestic corporation, then it seems reasonable to take foreign losses as well as income into consideration in the computation. Similarly, when there is foreign income, it should be included, but be subbject to the FTC to prevent double taxation. We do not see why worldwide income should be anything other than what it is for the taxable year under the theory of taxation now in use, and we do not support arbitrary manipulation of the FTC limitations in a way which will create some amount of double taxation.

Also, the contention that taxpayers receive a double benefit does not stand up well under analysis. In fact, the charge seems based on the idea that most foreign losses do not have the benefit of a local net operating loss carryforward, which we believe to be incorrect. To return to the loss-followed-by-profits example, it is true that worldwide income is depressed by the foreign loss in the year in which it occurs. However, where there is a local carryforward, worldwide income in the U.S. return increases in the later profitable year and raises U.S. tax liability, without offset by FTCs to the extent that the local loss carryforward erases local tax liability. There appears to be, in other words, a "wash" rather than a "double benefit," but for the minor timing advantage to the taxpayer.

As to other "complaints" sometimes heard about the per country limitation, we are aware that some tax rate averaging can be accomplished where a parent company's foreign subsidiary organization is set up with that in mind. Also, we recognize that the source rules are more difficult to administer under that limitation than under the overall. Regarding the former, it hardly seems to us that repeal is the appropriate remedy when there are other options, such as a grant of authority to the Treasury Secretary to impose constraints to prevent averaging. As to the latter, sourcing necessarily is more complicated under the per country limitation, but taxpayers who use the limitation seems able to cope with it. Repeal under these circumstances would be a drastic technique of simplification.

We support continuation of the per country limitation along with an elective overall limitation, with amendments if necessary to improve its operation.

Losses and the overall limitation.—The overall limitation has been criticized by some persons on much the same "double benefit" grounds as alleged in the case of the per country limitation. Briefly, where overall foreign losses exceed all foreign income in a given year, the excess of the losses can reduce U.S. tax on domestic-source income. Then, if the taxpayer later receives income from board on which he obtains an FTC, he is said to have "doubled up" the benefit. To reduce this "advantage," H.R. 10612 proposes recapture of tax benefits derived from the loss deductions by treating some foreign-source income as being domestic-source income and by denying an FTC or any deduction for taxes paid on that foreign income.

As already discussed in connection with the per country limitation, "double benefits" would appear to be the exception because of foreign loss carryovers. H.R. 10612 does not deal with this situation. Looking at this allegation of double benefits in a larger framework, we would point out that when foreign affiliates of U.S. taxpayers lose money, it is at least arguable that a jurisdiction purporting to tax worldwide income should not ignore them. Under the proposal, the U.S. Government, which keeps a residual claim to taxation of the foreign operation's income, here would be avoiding any part of the loss. Rather than say that worldwide income should disregard losses, which would be untenable, the House bill simply would recharacterize the source of various amounts for computation of the FTC limitation. Due to the recapture, it would appear that the combined U.S. and foreign taxes for a company upon recovering from its foreign loss could be rather high—a penalty tax situation just where it is not needed.

In our opinion, the Committee should reject this change to the overall limitation. At the least, it should except those cases where there are foreign loss carryovers.

Capital gains and the overall FTC limitation.—One provision of H.R. 10612 would have long-term capital gain from sources outside the United States be included in the limiting fraction only to the extent that the gain exceeds (1) long-term losses from sources outside the United States, *plus* (2) the excess of losses from all sales or exchanges of capital assets from sources within the United States over gains from the sale or exchange of all such assets (whether long-term or short-term gains and losses). A second adjustment would provide for rate adjustments to the net foreign-source gain (i.e., long-term capital gain included in foreign-source income) to recognize that capital gains and ordinary income are taxed differently under the U.S. federal income tax. A third provision would rule, with some exceptions, that no income from sales or exchanges of personal property outside the United States by a corporation or individual is to be treated as "foreign source" if the country of sale does not impose an income, war profits, or excess profits tax at least equal to 10 percent of the gain as computed under U.S. tax rules.

Briefly, we are concerned by the first two of these proposed changes, on netting and rate adjustments, because they would complicate an area of compliance and administration which already is a tangle of technicalities. It disturbs us that the House would approve this type of revision, the revenue consequences of which are not substantial, without so much as a word about the increased complexity it would introduce into compliance and administration. In our opinion, these technical "refinements" of the overall limitation are suspect on a cost-benefits basis and deserve reconsideration in that light.

Regarding personal property sold outside the United States by a U.S. taxpayer, the House has attempted to deal with an alleged problem of artificial sourcing aimed at using excess FTCs available from other activities. If there must be preventive legislation in this area, we think it is very important that the law not interfere with business transactions which do not have a U.S. income tax avoidance motive. The House provision does not succeed in this, and we find it unacceptable as a result. In our opinion, any such provision should be confined to situations where abuses are known to exist. Also, whether the legislation is limited in that way or not, it should provide an administrative determination procedure for a taxpayer entering into a business transaction in a country where a low tax on gain would be involved and none of the stated exceptions would apply.

Even with these changes, we question whether this legislation would be worth the complication it would add to the conduct of foreign trade. Revisions such as this one add to the complexity of doing business abroad; constitute pitfalls for unwary businessmen with no tax avoidance motives who just want to transact business; and make it practically impossible to engage in foreign trade safely without being tethered to costly tax advisers.

Exclusion for income earned abroad

In H.R. 10612, the House voted for repeal of the existing $20,000 (or $25,000) exclusion for income earned abroad by qualifying individuals, coupled with the enactment of several new allowances. We disagree with this action for three reasons. First, as the Committee is aware, the exclusion serves mainly as a tax relief mechanism for U.S. citizens working abroad, in conjunction with the foreign tax credit. This helps U.S.-based companies to attract qualified management people for foreign duty which, in turn, helps them to develop markets for their goods and services, including exports from the United States. Our domestic economic interests are well served by that activity. Second, the revenue loss from the exclusion is not substantial. Beyond that, the allowances which would be provided by the House bill in place of the exclusion would be more difficult to administer for government and taxpayer alike.

On the matter of tax relief, which is our main concern here, it often is less desirable financially for a U.S. citizen to work abroad than it is to remain in this country. U.S. taxes with respect to his income are a part of this financial equation, and the foreign tax credit alone does not always provide sufficient relief to the expatriate. The FTC allows only for foreign income taxes computed using U.S. tax principles whereas a larger proportion of the tax burden of the citizen abroad, as compared to the U.S. worker at home, typically consists of indirect taxes and income taxes often are assessed abroad in a way that is different from ours. We realize that the FTC cannot be changed to make it a *perfect* device for the avoidance of economic double taxation. Also, it is not a responsi-

bility of the U.S. revenue laws to achieve tax equalization for expatriates. However, the exclusion now threatened with repeal does improve on the performance of the FTC in avoiding double taxation of income earned abroad, and it does lighten the burden on employers of tax equalization.

Finally, a word about some notions which are current regarding equity as between persons employed abroad versus individuals employed in the United States. Examination over the years of employees in the United States will, we believe, demonstrate that most Americans characteristically are not very mobile, particularly after they have reached middle age or 10 years earlier than considered middle age. Their roots and the roots of their families go deep. This accounts in part for the fact that many companies try to offer an opportunity for their expatriate employees to return to the United States for a limited period on some sort of a regular basis. There are certain new factors which have developed and are quite relevant. Although inflation in the United States has been severe—although it is now moderating—inflation in many countries abroad has always been in excess of that experienced in the United States. This, of course, penalizes the employee working abroad and runs up the real cost of supporting a family abroad.

Another factor is not to be underrated. International murder and kidnap terrorism abroad is clearly a disincentive for U.S. citizens taking positions which require being based abroad. For example, I do not believe that I or any member of this Committee would look with favor on a business assignment in Argentina, Northern Ireland, or other countries with similar experience in the last few years.

We urge that the earned income exclusion be retained and, in view of inflation, we suggest that Congress consider increasing it to make up for the erosion in its value. If the Committee is disposed towards repeal notwithstanding the reasons for keeping the exclusion, we suggest that it first investigate the pattern of relief devices provided by other governments to their expatriates. The burden of eliminating this provision would fall on employers as well as expatriates and could be expected to reduce corporate export and foreign source income. We think the Committee should consider with care the extent to which repeal might thereby put U.S.-based companies at a disadvantage in competition with foreign-based organizations.

As a final thought on this subject, it is noteworthy that the House decided to provide other "adjustments" to take the place of the provision to be eliminated. These include special deductions for certain expenses incurred by employees in educating their children and an exclusion for the value of municipal-type services provided by employers. While any relief is better than none, one wonders about the wisdom of this swap in view of both the relative inadequacy and increased complexity of the replacement provisions. Even if we agreed with tax revisionists favoring repeal of Code section 911—which we do not—we could not be enthusiastic about substitute measures which are niggardly and cost ineffective.

Western Hemisphere Trade Corp.

H.R. 10612 would phase out the Western Hemisphere Trade Corporation (WHTC) provisions of the Internal Revenue Code. In support of repeal, the Ways and Means Committee stated that, among other things, it believes general tax equity requires that income derived from all foreign sources be taxed at the same rate. We suspect that the Congress responsible for WHTCs in 1942 felt the same way about tax equity, as a general matter. However, there were reasons for departing from that principle. Unfortunataely, the Ways ad Means Committee does not comment on whether it is still desirable to promote Western Hemisphere trade in this way beyond stating its feeling that DISC is a more appropriate incentive to the extent that incentives are needed for exports.

On DISC as a "more appropriate" incentive, several points come to mind. First, some companies have booth WHTCs and DISCs, and they use them in different ways for different transactions. Accordingly there are taxpayers who would disagree that DISC is more appropriate for all exports. Also, it should be emphasized that, despite some overlapping of the two tax relief mechanisms, they do not provide multiple tax benefits for single transactions. As another point, we find it ironic that at the same time that Ways and Means spoke of DISC as a "more appropriate" incentive, it was considering DISC repeal.

Also, the Ways and Means Committee stated that WHTC repeal was in order because the taxes imposed by other Western Hemisphere countries have been

substantially increased since the original enactment of the WHTC provision. Consequently, the Committee concluded, many companies which qualify as WHTCs receive little or no benefit from the deduction and, in many instances, the WHTC deduction merely adds to the complexity of preparing an income tax return without providing significant tax benefits. We disagree because it stands to reason that if WHTCs were found to be too complex and without significant tax benefits, then companies would not be using them.

Another reason given by the Ways and Means Committee for favoring repeal of WHTC was that the preferential tax rate given to WHTCs has "encouraged" U.S. manufacturers to set the prices on sales of goods to related WHTCs so as to maximize the income derived by the WHTC. There are any number of related-party situations other than the WHTC where this can occur, and the few taxpayers engaged in tax-avoidance pricing do so at considerable risk to themselves. One cannot realistically contend that WHTC should be repealed because it could be abused by persons who do not comply with the law.

Yet another reason given by the Ways and Means Committee for repeal of WHTC was that the "broad interpretation" given to the WHTC provisions by IRS has enabled corporations to obtain the benefits of those provisions for goods manufactured outside the Western Hemisphere by causing the title to the goods which are sold to the WHTC to be passed within the Western Hemisphere. In that situation, the Committee did not think it appropriate to give special tax relief. However, no explanation relating to the purposes of the WHTC provisions was given. Also, it appears that no consideration was given to excluding these transactions from WHTC use rather than repealing the entire mechanism.

Further on this matter of repeal, the Finance Committee should keep in mind that the WHTC provisions pre-date the General Agreement on Tariffs and Trade and, consequently, are not legitimately subject to objection by our major trading partners as a violation of that accord. Even if there were no other reason for retention of the WHTC provisions—a view with which we do not concur—it would seem unwise for Congress to act unilaterally to end this incentive now rather than leaving it intact for possible use in substantive deliberations during the "Tokyo Round" of trade negotiations.

To summarize, it is our understanding that WHTC still works to stimulate and facilitate trade in the Western Hemisphere. Moreover, it still aids U.S. exports and domestic employment as a part of that trade. In fact, for some companies, WHTC benefits are an important part of their competitive edge in maintaining shares of Western Hemisphere markets. If the Committee votes for WHTC repeal, it should first have concluded that it no longer is U.S. policy to encourage Western Hemisphere trade in this way, or that, contrary to our information, WHTCs have no substantial effect to that end. Also, the Committee should evaluate the "jobs" factor and the GATT consideration.

Before leaving the WHTC subject, from the standpoint of overall U.S. national policy and international policy, this comment is in order. As this Committee well knows, the United States, even after withdrawing from Vietnam, faces some international relationship problems and certain inflammatory situations in parts of the world which represent a threat to peace and to international relations. These special problem areas, which I need not enumerate, have distracted our attention from the Western Hemisphere where we have a very vital stake. We have been so preoccupied with other areas of the world that only recently has the distinguished Secretary of State Henry Kissinger visited Latin America. It seems untimely, therefore, to seriously consider elimination of a long-established position in the Revenue Code which encourages and assists business activity and business relationships with the principal trading countries in the Western Hemisphere.

We support retention of the WHTC provisions.

OTHER CORPORATE AND INDIVIDUAL INCOME TAX ISSUES

In this concluding portion of our statement, we have brief comments with respect to several other tax revision subjects in which the Institute has a continuing interest. Some have implications for capital formation, but most are administrative in nature.

Qualified stock options

H.R. 10612 would modify the present tax treatment of qualified stock options to make them like nonqualified options. As we see it, qualified stock options are

effective incentives to productivity and help in equity capital formation despite the restrictions imposed by the Tax Reform Rct of 1969. Accordingly, we favor their retention.

There are those who doubt that qualified stock options provide key employees of corporations with any more incentive than other forms of compensation, and they cite the stock market as being uncertain. We would simply respond that these options are distinctive if Congress will only leave them that way, and the Committee need only consult compensation specialists to find out that this is so. As to the stock market, it is uncertain in the short run. However, over time, it responds in a positive way to superior performance. Individuals with equity interests in corporations, including holders of qualified options, believe in and depend on that.

It is paradoxical to us that some tax revisionists embrace the Employee Stock Ownership Plan concept as a sure-fire productivity incentive, despite the fact that the stock is given away, but somehow doubt that qualified options are more effective than any other kind of compensation for employees who must earn the right to get them. We hope that the Committee will rethink this proposal.

Moving Expenses

H.R. 10612 would liberalize the moving expense provisions which were enacted as a part of the Tax Reform Act of 1969. The dollar limitation would be raised somewhat and the mileage limitation would be reduced. Although we approve the direction of this proposed revision, they do not go as far as they should, in our judgment. We would prefer to see changes in the limitations which are more favorable to employees on the move and to see a longer list of deductible expenses. Congress should recognize that more expenses of moving than now are listed in Code section 217 are *not* in the nature of compensation properly subject to withholding at the source, and so provide.

We note in passing that it would be a desirable objective of our tax laws not to impede the mobility of employees. Moving expense deduction provisions which do not allow employers to make transferred employees "whole," other than by inclusion of a federal income tax increment as if the amounts were taxable wages, are not consistent with this goal.

Advance rulings for certain transfers

As the Committee is aware, Code section 367 requires advance rulings in order to be certain of "tax free" status in certain transfers involving foreign corporations. There are problems with the provision. The advance ruling requirement often delays the consummation of affected business transactions, few of which undoubtedly have *any* federal income tax avoidance purpose, much less a principal purpose of that type. Also, exchanges subject to these requirements sometimes are consummated by foreign corporations without prior knowledge of the U.S. shareholders. Where this occurs, tax liability can arise even though a favorable ruling would have been issued by IRS had it been requested in advance. Another difficulty exists where IRS insists that a U.S. shareholder pay a toll charge even though there is no present tax avoidance purpose but only a potential for future tax avoidance.

Our principal concern with Code section 367 is the advance ruling requirement itself coupled with the fact that so much in the area seems left to administrative discretion. Despite IRS efforts to administer Code section 367 in a fair and expeditious way, inherently the procedure interferes with transfers to and from the United States which are entitled to tax-free treatment and, in many cases, will not be executed unless it is on that basis. We believe, too, that the current arrangement puts more of a burden on IRS than need be the case. On the other hand, U.S. tax policy with respect to these transactions is to allow tax-free treatment only if the federal income tax is paid or preserved on accumulated earnings and profits and on the potential earnings from such items as appreciated assets and inventory.

We have seen suggestions which would have the question of tax avoidance be left entirely for determination by the government on audit, subject to judicial review. This approach might silence some of the complaints of those who feel that advance ruling requirements interfere with business operations. However, it also would complicate government's task of administering the tax laws in this area. H.R. 10612 strikes a compromise of sorts between the interests of taxpayers and government in this matter, and we agree in principle with several of the changes which it would make. For one thing, as to some of these transactions,

U.S. taxpayers should be able to determine the tax effects based on the statute and regulations rather than being required to apply in advance to IRS. Also, where it is necessary for IRS to evaluate specific fact and circumstances, taxpayers should at least be permitted to obtain their rulings within some limited time after the transaction has occurred or commenced. Furthermore, there should be a procedure for taxpayer appeal of an adverse IRS determination.

Without reference to technical details of the proposals in H.R. 10612, we recommend that the Committee continue in the direction set there for improving the ruling process in regard to transfers abroad. Also, although some advance rulings would no longer be required, we ask that the Committee's report be worded to contemplate IRS' continued issuance of advance rulings for taxpayers wishing to have them. Finally, it might be desirable for the Committee to mention in its report some criteria by which Treasury might identify those transactions which do not require any filing of a ruling request, beyond those for which the section 367 toll charge can be ascertained without a ruling request. For example, objective tests for evaluating some planned transfers could be related to whether or not the taxpayer's federal income tax position would be materially changed by those transfers.

Private letter rulings

As a result of charges by some persons that IRS has dispensed "private law" through private letter rulings, a contention with which some courts have concurred, the Committee has before it the delicate issue of how best to alter the statutory base for public disclosure of these and certain other determinations (1) without substantial administrative inconvenience to IRS; (2) in a way that will end such allegations; (3) without interfering with operation of the ruling process; and (4) in a way consistent with Freedom of Information Act objectives and statutory confidentiality permitted for tax return material. H.R. 10612 attempts to strike this delicate balance, and does rather well under difficult circumstances.

However, we would prefer to see all taxpayer identification deleted from letter rulings which are available for public inspection. In our judgment, the "private law" charges no longer have merit where the determinations themselves are made available. We ask that this be reconsidered by the Committee because many taxpayers are sensitive about disclosure of their financial and other private circumstances, as well they are entitled to be. Privacy in tax return matters is fundamental in our taxing system, and the ruling process facilitates operation of the system. We should not want this process to be encumbered by unnecessary disclosure rules.

In conclusion, we desire to express again our apprecitaion for the opportunity to testify in these very important hearings.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

APPENDIX

RECENT MAPI STUDIES DEALING WITH CAPITAL FORMATION

"The Sad Story of Corporate Profits," by George Terborgh, March 1976

"Inflation and the Taxation of Business Income," by George Terborgh, January 1976

"SEC Amends Its Regulations To Require Supplemental Disclosure of Certain Replacement Cost Data," MAPI Bulletin 5418, March 26, 1976

"Inflation and Profits," by George Terborgh, MAPI Memorandum G-70 of January 1974, Revised and Republished in July and December 1974

"Fixed Investment and Productivity Growth in Major Industrial Countries, 1960–1973," MAPI *Capital Goods Review* No. 102, February 1976

"Corporate Financing of Economic Growth: Some Questions About the Mix of Internal and External Financing," MAPI *Capital Goods Review* No. 101, October 1975

"Corporate Saving and the Capital Shortage," by George Terborgh, MAPI *Capital Goods Review* No. 100, September 1975

"Another Part of the Story . . . Capital Formation and Exports," MAPI *Capital Goods Review* No. 98, June 1975

"Business Capital Formation—Putting It In Perspective (1925–1970)," MAPI *Capital Goods Review* No. 94, December 1973

"Inflows and Outflows Arising From U.S. Direct Investment Abroad, 1960–1975," MAPI Memorandum, March 26, 1976

The Favorable Impact of Direct Investment Abroad on the U.S. Balance of Payments: Spending More To Get More

One of the central issues in public policy debates about the economic effects of U.S. direct investment abroad has been its impact on the U.S. balance of payments. While we have from time to time discussed in broad terms the *overall* economic impact of U.S. *manufacturing* investment abroad,[1] we have not heretofore focused attention exclusively on the *balance-of-payments* impact of *total* direct investment overseas. That is the purpose of this *Review*.

One highlight of the findings of this analysis merits comment at this point. U.S. direct investment abroad has been the single most important factor in reducing our balance-of-payments deficits over the past 15 years. The surplus generated by such investment, which averaged $1.6 billion per year during 1960–62, had risen by 1972–75 to an annual average $7.9 billion.

The remitted earnings from these investments, which constitute an important part of the total net earnings of many companies, help create jobs and support critical activities of the corporate sector *in the United States*, including research and development, and various socio-economic programs such as pollution abatement and improvement in safety and health. Further, these earnings are, of course, subject to U.S. tax.

Trends in the Overall Balance of Payments

By way of providing a broad setting against which to consider the role of direct investment in the balance of payments, we will first look at movements in the overall balance and in major balance-of-payments sectors before undertaking a closer examination of the performance of the direct investment sector.

Table 1 shows movements in major items in the U.S. balance-of-payments accounts since 1960. Three-year annual averages are used in order to smooth out erratic annual movements. A four-year annual average is used for 1972–75—the period following the initial devaluation of the dollar which occurred in the summer of 1971. The balance-of-payments definition used in Table 1 (line 21) is "balance on current and long-term capital account" otherwise termed the "basic balance."[2]

There was a steady and substantial deterioration in the overall U.S. balance throughout the 1960s, and the annual average deficit reached a record high in 1969–71. While there has been some improvement during 1972–75 following the devaluation of the dollar, it has been small. Major adverse developments have been a sharply deteriorating trade balance, strongly rising capital outflows, and a huge increase in remittances abroad of earnings from foreign investments in this country.[3] Major favorable developments which have offset adverse trends in part have been the increase in incomes from U.S. investment abroad and the rise in long-term capital inflows.

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[1] See, for example, "The Role of U.S. Manufacturing Investment Abroad, 1950–66," Capital Goods Review No. 71, October 1967, and "The Role of U.S. Manufacturing Investment Abroad—An Analysis of Recent Trends," MAPI Memorandum FT–58, March 1975.

[2] This appears to be the most meaningful of the three definitions formerly used by the U.S. Department of Commerce. The other two definitions included short-term (including "hot") money flows and were considered particularly inappropriate in a world of fluctuating currencies.

Following the recommendation of an advisory committee, which recently completed a study of the balance-of-payments accounts, the government has discontinued publication of overall balances, on the basis that they are subject to incorrect interpretation. Nonetheless, the use of this particular measure appears appropriate, in our view, for considering our general balance-of-payments performance and the relative contributions of major balance-of-payments sectors.

[3] Income receipts and payments on U.S. direct investment abroad and foreign direct investment in this country (lines 10 and 18 of Table 1, respectively) include dividends, interest, branch earnings, and fees and royalties from direct investments. (For the treatment of branch earnings, see footnote 3 on page 4.)

PERFORMANCE OF THE GOVERNMENT VERSUS PRIVATE SECTORS

Viewing the balance of payments from another perspective, it is interesting to consider the proportions of the overall deficit attributable to the government and private sectors.[4] The items in Table 1 can be classified reasonably well into these two categories and the results of such a classification are shown in Table 2.

It can be seen from Table 2 that the government sector more than accounts for the deficits which have occurred as the private sector has generated sizable surpluses throughout the period under review. This is not surprising. The major government activity in the international area is the extension of grants and loans for military security or economic development purposes in areas which are not attractive to the private sector because they are not profitable.

It is clear at the same time that the continuation of large government programs is vitally dependent upon the private sector's ability to generate sufficient surpluses to finance these activities. Otherwise, we will confront further substantial devaluations of the dollar which could have serious adverse effects both for the U.S. and world economies.

The Private Sector in Closer Focus

It also can be seen from Table 2 that despite the favorable performance of the private sector, it has not been sufficient to finance the large increases in government spending abroad since 1960. In fact, there has been a small decline in the private sector's net favorable contribution to the balance of payments between 1960–62 and 1972–75, despite the devaluation of the dollar since 1970. By way of considering the reasons for the lack of improvement in the private sector balance, Table 3 shows, on a somewhat consolidated basis, those private sector items in Table 1.

The major factor underlying the failure of the private sector balance to register further improvement was the sharp deterioration in the merchandise trade balance. There were also adverse moves in services and private transfers (line 3 of Table 3), and increased net outflows resulting from private foreign investment in the U.S. (lines 6 and 7), but the deterioration in the foreign merchandise trade balance which showed an adverse swing of almost $5½ billion was the major factor.[5]

ROLE OF DIRECT PRIVATE INVESTMENT

The single major component in the balance of payments which has shown a favorable swing (more than $7½ billion) over the past 15 years is the surplus on private U.S. investment abroad (lines 4 and 5 of Table 3) and the major factor in this component was the increase in the surplus on direct investment account. Income from U.S. direct investment abroad exceeded capital outflow into such investment by an annual average $1.8 billion during 1960–62, and this had risen to $7.9 billion in 1972–75 for a net improvement of $6.1 billion.

In view of the role of U.S. direct investment abroad as the single most important income earner in the balance-of-payments account, it appears useful to consider developments in this sector in greater detail. This is done in Tables

[4] Admittedly, this is a somewhat simplistic approach, considering the interdependence of the two sectors. For example, government capital outflows no doubt provide significant support for U.S. exports. Indeed, because of the mutual interdependence of many of the individual items in the accounts, one must be cautious in interpreting developments in individual sectors. Nonetheless, a broad review of the general order of magnitude and direction of change of major sectors over an extended period provides, in most cases, sufficient evidence of performance, notwithstanding the interdependences.

[5] It might seem surprising at first glance that the trade balance showed a further modest adverse swing during 1972–75 in view of the devaluation of the dollar which should have substantially improved the world competitive position of U.S. producers. Two factors were responsible. The initial impact of devaluation in making imports more expensive and exports cheaper in dollar terms was to worsen the terms of trade with adverse short-term effects. Only as trade patterns change in response to the new exchange rates is there a net favorable impact. Unfortunately, the favorable effect of changing trade patterns was more than offset by the huge increases in the price of imported oil in 1974.

There was a very large favorable trade balance in 1975 (more than $9 billion), reflecting primarily the slowdown in imports associated with the U.S. recession, but this was not sufficient to offset the earlier deficits. Further, this surplus is expected to be sharply reduced or to disappear entirely in 1976 as the current economic recovery continues. A return to chronic deficits is widely expected and may already have occurred, as suggested by the trade deficits registered during January–March of this year.

4 and 5, which show direct investment broken down by major geographic region and major industry sector, respectively.[6]

Both tables show there has been a substantial surplus on direct investment account since 1960, and the surplus has widened sharply as rising outflows into foreign investment have been accompanied by substantially greater remittances to this country from those investments. There was a slight decline in the surplus during 1966–68 but it rose sharply in 1969–71 and has experienced a particularly steep rise since 1971.

PERFORMANCE OF INDUSTRIES

Industry performance by sector.—As can be seen in Table 5, petroleum accounted for four-fifths of the huge increase in the annual average direct investment surplus during 1972–74. The average annual surplus for petroleum increased to more than $5 billion from $850 million in 1969–71, while that for total direct investment rose to slightly more than $8 billion.[7]

The large contribution of the petroleum sector is explained in part by a major accounting adjustment associated with the partial foreign takeover of a U.S. Middle Eastern oil affiliate. Another factor of central importance, however, was the steep rise in profits resulting from the increase in Arab oil prices in 1974. Remittances from Middle East oil affiliates in the form of dividends, interest, branch earnings,[8] fees, and royalties rose from $2 billion in 1972 to $8½ billion in 1974. It appears that roughly half of the latter is attributable to the foreign takeover.

Turning to other sectors, both manufacturing and other nonpetroleum industries show a generally rising trend in the surplus on direct investment account throughout the period under review. Since the late 1960s, however, the increases have been substantially greater in manufacturing. In the case of all sectors, recent increases—especially those since 1971—can be attributed importantly to accelerating inflation which led to a corresponding acceleration in both remittances and outflows. In addition, the devaluation of the dollar in terms of foreign currencies has been an important factor inflating the dollar value of most foreign currency payments and receipts.

Industry performance by region.—The regions contributing most to the favorable balance through a large part of the period reviewed were Latin America and Asia-Africa-Oceania (Table 4). In the case of Europe, outflows *exceeded* remittances during the first half of the 1960s. The European deficit is somewhat misleading, however, in that it was more than accounted for by petroleum.

Most of the overseas earnings in the petroleum industry are generated in the producing sector rather than in refining or marketing. Taking all areas combined, the petroleum sector accounted for roughly two-fifths of the favorable balance on direct investment account during most of the period reviewed in Table 5. However, more than half the favorable balance in Latin America has typically been accounted for by petroleum, while that sector has accounted for some three-fourths to more than four-fifths of the balance in Asia-Africa-Oceania. On the other hand, in Europe where refining and marketing operations are of substantially greater relative importance, the petroleum sector balance has been negative throughout the period under review. Capital outflows have been 4½ times the level of remitted earnings which, although increasing throughout the period, remain relatively small.

The geographic patterns for manufacturing and other sectors have differed notably from those for petroleum.

Manufacturing surpluses have been large and trended generally upward in both Europe and Canada. They have increased much more rapidly in Europe, however, and during 1972–74 comprised more than one-half the total manufacturing surplus for all areas as compared with one-fourth in Canada. In Latin America manufacturing surpluses have been small and have moved irregularly,

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[6] Table 5 extends only through 1974, because industry data for 1975 are not presently available.

[7] The annual average was $7.9 billion during 1972–75 (Table 4).

[8] The accounting treatment of branch operations abroad deserves some comment, especially since this is a common mode of operation for the petroleum companies. Total branch earnings are counted as remittances to the United States. Those earnings not actually remitted are treated as capital outflows. Balance-of-payments surpluses are not affected by this approach, but both remittances and outflows are overstated on that account.

showing little trend as rising remittances have been generally offset by increased capital outflows. A similar pattern held true for Asia-Africa-Oceania in the early years of the period. However, the surpluses have increased sharply since the late 1960s as remittances have shown large increases while outflows have exhibited relatively little change.

The surplus on direct investment in other nonpetroleum sectors has also risen notably both in Europe and in Asia-Africa-Oceania. In the case of Europe, the increases which have been particularly large are attributable primarily to the trade, finance, and insurance industries. Surpluses have also been substantial in Latin America due to activity in the trade, finance, insurance, and mining and smelting sectors, but they have shown relatively little change over the period as increased remittances have been matched by the rise in capital outflows.

The surplus for "other" nonpetroleum sectors in Europe in 1972–74 was roughly two-fifths that for all areas. It represented a bit less than one-fourth of the total in Asia-Africa-Oceania and in Latin America.

RELATION OF DIRECT INVESTMENT SURPLUSES TO CAPITAL OUTFLOWS AND THE LEVEL OF INVESTMENT

A major factor in relative changes of the direct investment surpluses among major areas and industry sectors is the differential changes in the *level* of direct investment from one area and one sector to another.[9] Investment levels are influenced importantly by the volume of investment capital flowing abroad and the level of reinvested earnings which are the two major components accounting for increases in fixed investment. The expansion in earnings accompanying increases in the value of direct investment permits more funds to be remitted to the U.S. and also makes available additional funds for reinvestment, thereby expanding further the earnings base. This explains the cumulative long-term favorable impact of rising direct investment outflows on the balance of payments.

The cumulative outflow of U.S. direct investment capital into European manufacturing was almost three-fifths of the total outflow into manufacturing abroad during 1960–74. These heavy capital outflows account for the rise in the level of U.S. investments in Europe from one-third of total manufacturing investment abroad in 1960 to one-half in 1974. The corresponding rise in manufacturing earnings over this period permitted a rapid increase in earnings remittances to the U.S. As a consequence, the increase in total remittances (interest, dividends, branch earnings,[10] and direct investment fees and royalties) substantially outstripped the rise in outflows, accounting for the rapid rise in the surplus on direct investment account. The surplus rose from 10 percent of the total surplus from manufacturing investments abroad in 1960–62 to more than half of the total in 1972–74.

A sharply contrasting picture is shown for Canada. The value of U.S. manufacturing investments in Canada was more than two-fifths of total manufacturing investment abroad in 1960. However, capital outflows into Canadian manufacturing investments during 1960–74 were little more than one-tenth of total such outflows. As a consequence, the value of manufacturing investment in Canada declined to one-fourth of total such investments abroad by 1972–74; earnings on these investments rose very slowly; there was a correspondingly slow growth in remittances as well as reinvestments; and despite (or rather because of) the low level of capital outflows, the surplus on the manufacturing investment account grew so slowly that the Canadian share of the surplus on all manufacturing investment abroad declined from roughly two-thirds in 1960–62 to one-fourth by 1972–74.

A similar pattern is shown in other, nonpetroleum sectors. Capital outflows into investments in Europe represented one-third of total such outflows during 1960–74 and the value of these European investments rose from one-tenth to almost one-third of total such investments abroad. As a consequence, notwithstanding the heavy outflow of capital, the surplus deriving from direct investment in European industry other than manufacturing and petroleum, rose from one-eighth of the surplus on total such investment abroad in 1960–62 to more than one-third by 1972–74.

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[9] In the case of the petroleum sector, other factors are predominant as discussed earlier.
[10] See footnote 3 on page 4.

As for Latin America, direct investment outflows into these economic sectors were less than one-fourth total outflows to all areas, and the value of investments declined from two-fifths to less than one-fourth total such investment abroad between 1960 and 1974. As a result, the surplus declined from two-thirds of the total surplus on direct foreign investment in these sectors in 1960–62 to one-fifth in 1972–74.

CONCLUSION

This review shows clearly the key role of the U.S. direct investment sector in reducing the U.S. balance-of-payments deficits over the past 15 years. In the absence of these investments, our deficits would have been greater by several billion dollars.

It is also clear that the cumulative long-term impact of rising direct investment outflows on the balance of payments is highly favorable since they generate a substantially greater increase in earnings and remittances. The finding that the U.S. surplus on direct investment abroad rose from an annual average $1.8 billion during 1960–62 to $7.9 billion by 1972–75 despite the rise in direct investment outflows from $1.6 billion to $5.4 billion is nothing short of dramatic.

The conclusion is obvious. Measures that would restrict U.S. capital outflows would have a highly adverse balance-of-payments effect over the longer run and to that extent would clearly be self-defeating.

Further, as we noted at the outset, the repatriated earnings from these investments expand the U.S. tax base, help create jobs, and support a variety of *domestic* corporate programs, including research and development, pollution abatement, and improvement in safety and health.

TABLE 1.—U.S. BALANCE OF PAYMENTS—MAJOR INTERNATIONAL TRANSACTIONS, ANNUAL AVERAGES

[In millions of dollars]

	1960–62	1963–65	1966–68	1969–71	1972–75
1. Merchandise trade balance[1]	4,995	5,659	2,751	314	−422
2. Services	−976	−1,050	−1,215	−1,415	−1,676
3. Military transactions	−2,599	−2,186	−3,101	−3,192	−2,229
4. Remittances, pensions, and other transactions	−666	−913	−1,178	−1,479	−1,748
5. Long-term U.S. capital outflows	−5,525	−7,758	−8,188	−9,462	−14,537
6. Direct investment	−1,642	−2,591	−3,192	−4,070	−5,428
7. Other private	−1,035	−1,647	−1,107	−1,692	−4,185
8. Government (including U.S. Government grants exclusive military grants)	−2,847	−3,520	−3,889	−3,700	−4,924
9. Receipts of income on U.S. investment abroad	4,589	6,348	7,630	10,465	19,788
10. Direct investments[2]	3,406	4,623	5,137	7,004	13,282
11. Other private	781	1,233	1,824	2,550	5,561
12. Government	402	492	669	911	945
13. Long-term foreign capital inflows	530	385	2,887	3,576	6,295
14. Direct investment	115	16	221	562	1,798
15. Other private	267	67	2,579	3,246	3,529
16. Government	148	302	87	−232	968
17. Payments of income on foreign investment in the United States	−1,105	−1,570	−2,547	−4,886	−10,820
18. Direct investments[12]	−245	−307	−449	−603	−2,425
19. Other private	−544	−815	−1,482	−3,068	−4,564
20. Government	−316	−448	−616	−1,215	−3,831
21. Balance on current and long-term capital account	−757	−1,086	−2,961	−6,115	−5,349

[1] There was a break in the "merchandise trade balance" series beginning in 1970. Both exports and import were revised to incorporate the results of the U.S.-Canadian trade reconciliation conducted by the U.S.-Canada Trade Statistics Committee. (Reconciliations are not available for years prior to 1970.) The net effect was to increase the 1970 surplus by $400,000,000 and to reduce the 1974 deficit by $800,000,000.

[2] Includes direct investment fees and royalties.

Source: U.S. Department of Commerce.

TABLE 2.—U.S. BALANCE OF PAYMENTS—GOVERNMENT VERSUS PRIVATE SECTOR, ANNUAL AVERAGES[1]

[Millions of dollars]

	1960-62	1963-65	1966-68	1969-71	1972-75
Government	−5,444	−5,664	−7,254	−7,898	−9,763
Private	4,686	4,578	4,293	1,783	4,414
Balance on current and long-term capital account	−758	−1,086	−2,961	−6,115	−5,349

[1] The Government sector includes lines 3, 8, 12, 16 and 20 and the Government portion of line 4 in table 1.

Source: U.S. Department of Commerce.

TABLE 3.—U.S. BALANCE OF PAYMENTS—PRIVATE SECTOR TRANSACTIONS, ANNUAL AVERAGES[1]

[Millions of dollars]

	1960-62	1963-65	1966-68	1969-71	1972-75
1. Merchandise trade balance	4,995	5,659	2,751	314	−422
2. Services	−976	−1,050	−1,215	−1,451	−1,676
3. Private remittances, pensions and other transactions	−435	−610	−773	−1,010	−1,056
Income from U.S. private investment abroad less capital outflow into private investment:					
4. Direct investment	1,764	2,032	1,945	2,934	7,854
5. Other private	−255	−414	717	858	1,376
Payments on foreign private investment in United States less capital inflow into private investment:					
6. Direct investment	−129	−291	−228	−41	−626
7. Other private	−277	−748	1,097	178	−1,035
8. Balance on current and long-term private capital account	4,686	4,578	4,294	1,783	4,415

[1] The data of this table are taken from table 1. Line 3 equals the private portion of line 4 in table 1.

Source: U.S. Department of Commerce.

TABLE 4.—U.S. BALANCE OF PAYMENTS—TRANSACTIONS RELATING TO U.S. DIRECT PRIVATE INVESTMENT ABROAD—MAJOR WORLD AREAS, ANNUAL AVERAGES

[Millions of dollars]

	1960-62	1963-65	1966-68	1969-71	1972-75
Europe:					
Remittances	727	1,071	1,257	1,993	3,659
Capital outflows	−851	−1,264	−1,418	−1,767	−2,439
Balance	−124	−193	−161	226	1,220
Canada:					
Remittances	563	785	962	1,095	1,485
Capital outflows	−356	−542	−580	−470	−452
Balance	207	243	382	625	1,033
Latin America:[1]					
Remittances	959	1,184	1,319	1,359	1,806
Capital outflows	−132	−207	−441	−553	−1,116
Balance	827	977	878	806	690
Asia-Africa-Oceania:					
Remittances	1,130	1,536	1,499	2,173	5,935
Capital outflows	−272	−539	−659	−909	−1,131
Balance	858	997	840	1,264	4,804
Other:[2]					
Remittances	27	47	100	384	397
Capital outflows	−31	−39	−94	−371	−290
Balance	−4	8	6	13	107
All areas:					
Remittances	3,406	4,623	5,137	7,004	13,282
Capital outflows	−1,642	−2,591	−3,192	−4,070	−5,428
Balance	1,764	2,032	1,945	2,934	7,854

[1] Includes all Western Hemisphere countries other than Canada and the United States.
[2] Includes primarily transactions with shipping, finance, and insurance companies whose activities cannot be assigned to any particular world area.

Source: U.S. Department of Commerce.

TABLE 5.—U.S. BALANCE OF PAYMENTS—TRANSACTIONS RELATING TO U.S. DIRECT PRIVATE INVESTMENT ABROAD—MAJOR INDUSTRY SECTORS, ANNUAL AVERAGES[1]

[Millions of dollars]

	1960-62	1963-65	1966-68	1969-71	1972-74
Manufacturing:					
Remittances	1,051	1,436	1,711	2,416	3,877
Capital outflows	−673	−1,093	−1,260	−1,346	−1,913
Balance	378	343	451	1,070	1,964
Petroleum:					
Remittances	1,444	1,935	1,675	2,303	6,490
Capital outflows	−609	−872	−1,021	−1,452	−1,404
Balance	835	1,063	654	851	5,086
Other:					
Remittances	911	1,252	1,751	2,285	3,161
Capital outflows	−360	−626	−911	−1,272	−2,001
Balance	551	626	840	1,013	1,160
All sectors:					
Remittances	3,406	4,623	5,137	7,004	13,528
Capital outflows	−1,642	−2,591	−3,192	−4,070	−5,318
Balance	1,764	2,032	1,945	2,934	8,210

[1] Only preliminary figures for interest and dividend remittances, branch earnings, and capital outflows are available for individual industry categories prior to 1966. Data showing direct investment royalties and fees are not available on an individual industry basis prior to 1966. Royalties and fees were estimated based on 1966–74 patterns. These estimates together with the preliminary data were adjusted to the revised figures for all sectors combined which are available for these years.

Source: U.S. Department of Commerce.

Senator BYRD. The next witness will be Mr. Malcolm R. Lovell, Jr., president, Rubber Manufacturers Association.

STATEMENT OF MALCOLM R. LOVELL, JR., PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION, ACCOMPANIED BY EDWARD WRIGHT, VICE PRESIDENT OF ECONOMIC AFFAIRS OF AMERICAN RUBBER MANUFACTURERS ASSOCIATION

Mr. LOVELL. Thank you, Mr. Chairman, I am Malcolm Lovell and I have with me Mr. Ed Wright, vice president of economic affairs of American Rubber Manufacturers Association.

With the time limitations I know you face, I would like to have my statement submitted for the record and I will highlight some of the points that I think may be of interest.

I would like to concentrate on two principal points. One is the need for greater capital formation and the other comments are in terms of foreign source income.

Mr. Chairman, I think probably one of the most serious problems facing this country today is to develop the capital to do the things we need to do. This is principally in the area of energy where we have to replace fossil fuels in about 20 years, which will take hundreds of billions, but it is also in the area of capital formation to provide economic expansion necessary to maintain the kind of employment objectives we have.

One cannot develop jobs by having Government provide an income for them. When I was in the Labor Department, I had a lot of experience in public employment, and it really does not provide the answer for a full-employment society.

What we do need is to have an economy that is strong, growing, and expanding, and can provide the work. That takes capital. I think that takes generally $40,000 for every job.

Senator HANSEN. How much?
Mr. LOVELL. $40,000.

I thought that today I would give you some examples from our industry which I think is a fairly typical industry. We are a medium-sized industry. We produce goods for consumers and for industrial use. We are not a regulated industry, although I guess every industry is regulated to some extent. We are a highly competitive industry.

I think perhaps the experience we have had over the last 10 years and the experience we see ahead will be of interest to this committee as you tackle what I feel is probably the most serious responsibility over the next decade in terms of our tax program and the encouragement of capital formation.

The rubber manufacturing industry has sharply mounting corporate debt burdens and our prospects for meeting future investment needs under existing tax policy are rather grim. I would like to give some examples.

In 1964, the ratio of debt to equity was 33 percent. In other words, 33 percent of the equity, owner's equity, was the amount of long-term debt that the industry had. Ten years later, it is in excess of 64 percent.

As a matter of fact, that figure is conservative. It is closer really to 100 percent if you take a look at all of the accounting aspects that go into it. It is 33 percent to over 100 percent in 10 years.

What does that mean? It means the ability to float new debt is decreased because the value of the bonds and their issue is lessened because there is less behind it.

The ability to launch new capital stock issues is decreasing. So, it is a very serious problem that has developed over the 10 years in our industry that the debt rate has increased so much.

As we look ahead, over the next decade, we find that there is a tremendous need for continued capital investment and for a number of reasons.

One is in order to produce the number of jobs the industry is capable of producing, we are going to have to continue to expand the capacity to produce radial tires. Radial tires require more capital and cost more than what is now conventional or ply. The equipment and machinery is more expensive and requires 20 to 40 percent more labor. In order to keep the share of the market we now have, and the foreign market has continued to expand into our American market, we are going to have to expand in the area of developing greater capability on radial tires.

In addition to that, efficiency of the plant and equipment used have to be improved. We have to put huge sums as our scientists develop tires. As new technology develops in the tire field, and you may have heard about the quest for tires which make the spare tire unnecessary. Our energy requirements for automobiles are demanding the 50 pounds in spare tire and jack be eliminated and the space be eliminated. I believe that either 100 million or 100 billion barrels of oil a year can be saved by elimination of that weight. All of this requires capital investment. In addition to that, of course, it has been mentioned by the previous speakers that there are big demands on American industry for capital which will help improve the environment and safety and other socially desirable objectives. This is an objective we have set for ourselves as a nation. Some of it is unrealistic and some is not. So, there will be a continued need for capital in this area.

The suggestions we have made as to how this should be done really, I think, are more illustrative and current than they are inclusive. I suspect that this committee and this Congress is going to have to think of even more imaginative ways to encourage capital formation not only by the individual, but by individuals, and it is a very hard political job because almost by its very nature those who are apt to save are in higher income brackets. Encouragement runs against certain political grains but it has to be done.

What magic formula you can use to do this, I don't know, but it is not really my position to recommend. But certainly, it will be necessary to encourage private investment as well as additional capital formation in industry.

Another suggestion we are making, of course, following recommendations made by the U.S. Chamber of Commerce and the NAM, is with regard to depreciation allowances and the need to eliminate double taxes of dividends. Again, when we are talking about double taxation of dividends, you can do it one of several ways. You can reduce the tax on the individual which I think probably is politically more difficult or even allow the corporations to treat a dividend the same way it would an interest payment. I would imagine it would be a politically easier thing to do. Corporations are not individuals and equitable tax bills deal with individuals and not institutions, but the corporations and institutions which provide jobs and income in this country, the private sector has done very well in that regard. I think one of the great problems we have in convincing the American people that the American corporation is an instrument that a free society has chosen to advance the total economic needs of the Nation and not some evil system that is strangling the poor. It is providing the highest standard of living of any nation in the world. Certainly we need to do those things to increase its ability to move in that direction.

Suggesting that depreciation allowances be increased, the NAM has urged the adoption of a 5-year period for machinery and plants and we support that.

Senator BYRD. Your time has expired and your full statement will be printed in the record.

Senator Curtis.

Senator CURTIS. I agree with you on the need for capital in many, many fields. The administration has recommended that taxpayers be allowed a deduction from earned income, up to $1,500 a year, for the purchase of common stock. Do you think that would be a positive step toward making more capital available?

Mr. LOVELL. Yes, I think it is one of a number of things that could be used to encourage the purchase of common stock, particularly by lower income people. I don't think you can do it for higher income people. Your chairman, Mr. Long, has suggested employee stock saving or purchase concepts. I was with American Motors when we negotiated an agreement with Walter Reuther that gave employees these rights. I think it has a psychological value. How it works over time, I don't think anyone really knows but that concept makes sense to get people to save.

Senator CURTIS. The administration's "BSOP" proposal would make this option available to someone who makes $20,000 or less and it would phase out as income reaches $40,000.

I do not know the answer to this question, but I would like to ask whether this would be more effective if the investment had to be made in new issues rather than just purchasing shares that are already outstanding?

Mr. LOVELL. I am not a stock analyst, Senator, but I would worry a bit about it because people could also sell older shares and buy newer shares.

Senator CURTIS. Whatever increase in overall investment that results would eventually be of benefit to all.

Mr. LOVELL. That is correct. Any tax enactment that will encourage individual saving or encourage a greater access of capital to corporations is going to be useful.

Senator CURTIS. I am fully aware that there are a lot of reasons why those who manage a large corporation are limited in the kind of encouragement or "sales talks" they can give to employees. It seems to me if the BSOP proposal were enacted, that it would be a vehicle whereby employees and concerns that employ a good many thousands of workers could encourage them to become owners and at the same time, to provide a substantial tax reduction for a group that could well use it.

Mr. LOVELL. I think it would be very well in that regard.

Senator BYRD. Senator Hansen.

Senator HANSEN. On page 8 of your testimony, Mr. Lovell, you say in the first full paragraph in the rubber manufacturing industry, hourly wages rose from an average of $2.75 per hour in 1963 to $4.72 per hour in 1974, an increase of 71.6 percent during the time period the employee costs borne by rubber manufacturing companies for what were once called fringe benefits increased a staggering 300 percent, from an average of 99 cents per hour to $3 per hour.

Do I accurately infer from that statement that your total costs per employees would be the sum of $4.72 per hour in direct wages plus the $3 per hour in fringe benefits?

Mr. LOVELL. Yes, that is correct. It is around $8 for the entire industry and it is around $9 for the tire industry itself.

Incidentally, the demands of the United Rubber Workers presented for an additional $9 an hour is for an additional increase over a 3-year period.

Senator HANSEN. I live in a part of the country where we still wear overshoes. As a youngster, I remember the old Red Ball brand overshoes. I don't know who makes them now, but the last pair I got still bore that old trademark, but I notice they were made in, I believe in Korea. Would that be right?

Mr. LOVELL. It could well be. The footwear industry, including the rubber footwear industry, has been really deluged with competition from overseas. I think it is about 60 percent.

Senator HANSEN. What is the significant factor that gives advantage to a foreign importer?

Mr. LOVELL. It is labor costs.

Senator HANSEN. I understand Japan, at one time, was able to take many of the industries, those that were labor intensive from this country and now they, too, reflecting the rising costs of wages in Japan

are exporting that kind of production to countries where wages are less than they are in Japan even; is that right?

Mr. LOVELL. That is right.

[The prepared statement of Mr. Lovell follows:]

STATEMENT OF MALCOLM R. LOVELL, JR., PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION

SUMMARY OF PRINCIPAL POINTS

Capital formation

1. The tire manufacturing industry may be regarded as broadly representative of the entire rubber manufacturing industry and of U.S. manufacturing companies generally.

2. In the past 10 years there has been a striking increase in the corporate debt of tire manufacturing companies. Specifics are given.

3. This increase has occurred because a large volume of capital investment was required to implement certain major technological changes and the investment could not be financed by internal funds generated through depreciation allowances and additions to retained earnings.

4. An upper practical limit on corporate debt has been reached by many tire manufacturing companies.

5. Unless major reforms in corporate tax laws are forthcoming there are serious social and economic consequences ahead for the United States through the future investment-depressing effects of existing tax rules. Specific consequences regarding the tire manufacturing industry, as an illustrative industry, are discussed.

6. Tax legislation reform urgently recommended includes: establishing more realistic depreciation rules, phasing out double taxation of corporate dividends, and employing special investment incentives for some time.

Foreign source income

1. An RMR statistical study of major trade, employment and investment facts related to the operation of multinational tire manufacturing companies over a 10-year period is summarized.

2. The study establishes that U.S. national self-interest has been strongly served by the positive effects on U.S. employment, U.S. balance of payments, and U.S. investment decisions of the multinational tire manufacturing companies.

3. Proposed changes in existing tax rules as applied to (a) DISC, (b) So-called tax deferral on the income of overseas subsidiaries, and (c) LDC corporations are discussed and the existing rules strongly defended.

Mr. Chairman: I appreciate the opportunity to appear today before the Senate Committee on Finance to discuss two tax subjects of great concern to members of the Rubber Manufacturers Association. One is the need for major reform in our tax laws affecting capital formation. The second is sensible tax treatment of foreign source income. These important subjects are actually inter-related. I will devote most of my brief time, however, to discussing capital formation.

CAPITAL FORMATION

You have already heard excellent presentations from Secretary Simon, the NAM, the Chamber of Commerce, the American Institute of Certified Public Accountants, and others on the imperative need for a major revision in U.S. tax treatment of corporate income, capital gains, and the incentives for saving and investing if we are to redress some alarming developments and ominous trends in our economy. Secretary Simon expressed his "deep concern that [a] failure to increase the rate of capital formation can have profound consequences for our economy for years to come." He explained that his concern derives from the fact that declining rates of growth in U.S. output per worker, the eroding competitive position of U.S. industry, inflationary pressures from production capacity shortages, and a persistently high level of unemployment are closely related to an inadequate level of capital investment in the United States in recent years.

This inadequate level of investment—for which U.S. tax laws are primarily responsible—must be reversed if we are to confront international business competition successfully in the future, restrain price increases better, reduce our disturbingly high level of unemployment, and permit government-financed social service programs to operate without dragging down the rest of the economy. As Secretary Simon said: "[I]f efforts to improve capital formation and increase the efficiency of capital use are not undertaken, Americans will pay in the future through lower standards of living and poorer employment opportunities." Major changes in our corporate tax laws are needed, moreover, not only to redress the disturbing strains in our economy that are apparent but to permit American companies to respond affirmatively to new and emerging investment demands springing from the energy crisis, environment requirements, and a need for costly improvements in worker health and safety.

I will not try to replow the analytical ground linking our low and inferior level of capital investment in the United States to specific tax provisions in our laws. This has been ably done by others. What I would like to discuss relates closely to the passages in Secretary Simon's March 17 statement to you calling your attention to the important shift that has occurred in the past 10 years in the principal means used by corporations to raise long-term funds for investment purposes, and its implications for the future. Secretary Simon stated:

"For many years there has been a discernible trend toward growing dependence by business on outside funds to finance their growth . . . The growing dependence on external financing . . . began in the mid-1960's and has risen steadily since then . . .

"Analysis of debt-equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade . . . Debt has increased dramatically, both in absolute terms and relative to assets and income. Interest costs have risen appreciably, roughly doubling over the past ten years. The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by American corporations—that is, the ratio of earnings to interest charges . . . As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals . . .

"The implication of these fundamental shifts in the patterns of financing is that the structure of corporate balance sheets is more brittle and less liquid than it was 10 years ago. Obviously there is no single level where the corporate financial structure suddenly becomes too illiquid and inflexible, but at the same time an ever higher burden of debt commitments relative both to financial assets and to income is a matter for some concerns . . . [T]he potential for bankruptcy has greatly increased across the entire spectrum of U.S. business. This potential in and of itself will discourage future investment as lenders become more reluctant to make long-term commitments and companies become less willing [to add to their] debt obligations. Some investments which would have been undertaken in earlier periods will be passed over in the future.

It must be emphasized that American corporations in the past 10 years have resorted to a means of financing their capital investment requirements that cannot be utilized to the same degree in the future. For this reason even the inadequate investment levels we have experienced in recent years are unlikely to be maintained without major changes in our tax laws. We are not confronting a distant problem, therefore, whose solution can be postponed to tomorrow. Congress needs to address the needs for sound capital formation and investment-stimulus laws without delay.

While leaving the broad case for capital formation reform primarily to others, I *would* like to bring the general case down to the specifics of our particular industry. Specific cases sometimes make general principles easier to understand. I believe it would be helpful to the Committee if I discussed some of the recent, and foreseeable, effects in the rubber manufacturing industry of inadequate capital recovery rates, sharply mounting corporate debt burdens, and our prospects for meeting future investment needs under existing tax rules.

While the statistics I have available relate primarily to the tire manufacturing sector of the rubber manufacturing industry I have no doubt they are representative of the entire industry. Tire manufacturing in fact is probably typical of U.S. manufacturing companies generally. It is an industrial field which does not enjoy any special tax advantages or disadvantages, it is not an industry whose

profits are regulated by a government agency, its firms are in strong competition with each other and with foreign firms whose penetration of the U.S. market in recent years has been growing.

Changes in rubber manufacturing industry debt burdens

In 1964, approximately ten year ago, the dozen tire manufacturing companies that are currently members of RMA had an aggregate ratio of long term debt-to-equity of 33%—that is, shareholders equity was three times greater than corporate debt of more than one year. In that year corporate debt totaled $860,000,000 while stockholders equity was $2,632,000,000. Within five years the debt-to-equity ratio changed strikingly. From 33% in 1964 it mushroomed to 56% by 1969. By 1974, five years later, the debt-to-equity ratio increased further to 64%. Over the 10 year period, total long term corporate debt grew 400%, to $3,313,000,000, while stockholders equity grew only 200%, to $5,181,000,000. The 64% figure, moreover, is deceptively low. For in recent years resort has been made deliberately to off-balance-sheet financing of various intrinsic debt items, such as unconsolidated joint ventures and captive finance companies, together with an unprecedented use of lease arragements, to keep conventional balance sheet debt-to-equity ratios for credit purposes as low as possible.

In a recent study by Paine Webber of the debt quality of tire and rubber manufacturers,[1] for five major companies the combined off balance sheet financing and non-cancelable leases were estimated to represent an additional 29% of balance sheet equity in 1974. Hence, from a practical standpoint, over an eleven-year period long-term corporate debt changed from one-third of stockholders' equity to almost as much as stockholders' equity. In the same period, the Paine Webber study reports that total corporate liabilities as a percent of stockholders' equity for eight major companies in the industry changed from 85.7% in 1965 to 152.8% in 1974.[2]

The basic reasons for this striking increase in debt for tire manufacturing companies are twofold: (1) a high level of capital improvements have been required in the past 10 years to stay abreast of major technological changes implemented by U.S. or by foreign competitors, and (2) the investments necessary for plant and equipment could not be financed adequately out of internal cash funds generated by retained earnings and allowable depreciation, nor raised through additional share offerings.

The most prominent of the technological changes I refer to were, first, the advent in the late 1960s of bias-belted tires, which represented a significant improvement in safety and durability over earlier bias-ply tires, and, second, the more recent advent of radial tires, which siginficantly out-perform tires of earlier construction in safety, durability, and gasoline economy. Both shifts in production emphasis have transpired over a period of years but nevertheless have been charactrized by the need to accomplish ncessary investment activity in a relatively short period of time to respond to market demand and to stay abreast of competitors.

The Census of Manufactures reports that in the 5 year period 1965–1969 the tire and inner tube industry spent $1.1 billion for new plant and equipment. In the 5 year period 1965–1969 the increase in total corporate debt I mentioned a moment ago was $1.8 billion. Most of the additional debt went for new plant and equipment or was required to carry the higher inventory costs associated with a more expensive product line.

For the period 1970–1974, the accompanying chart on p. 7, drawn from the Paine Webber study, illustrates graphically why further increases in debt were required to help finance the new additions to plant and equipment, and even higher inventory carrying costs, associated principally with the shift to radial tire production. In this 5-year period, outside financing of over $1¼ billion dollars was required by the five major original equipment tire manufacturers since internally-generated funds were incapable of managing the load.

Once a major technological change occurs and is reflected in the market's demand for an industry's products a manufacturer's existing plant and equipment can become obsolete very quickly. Like it or not, in most cases new investment must be made promptly by small as well as large manufacturers for the alternatives are either to go out of business or henceforth serve a secondary market.

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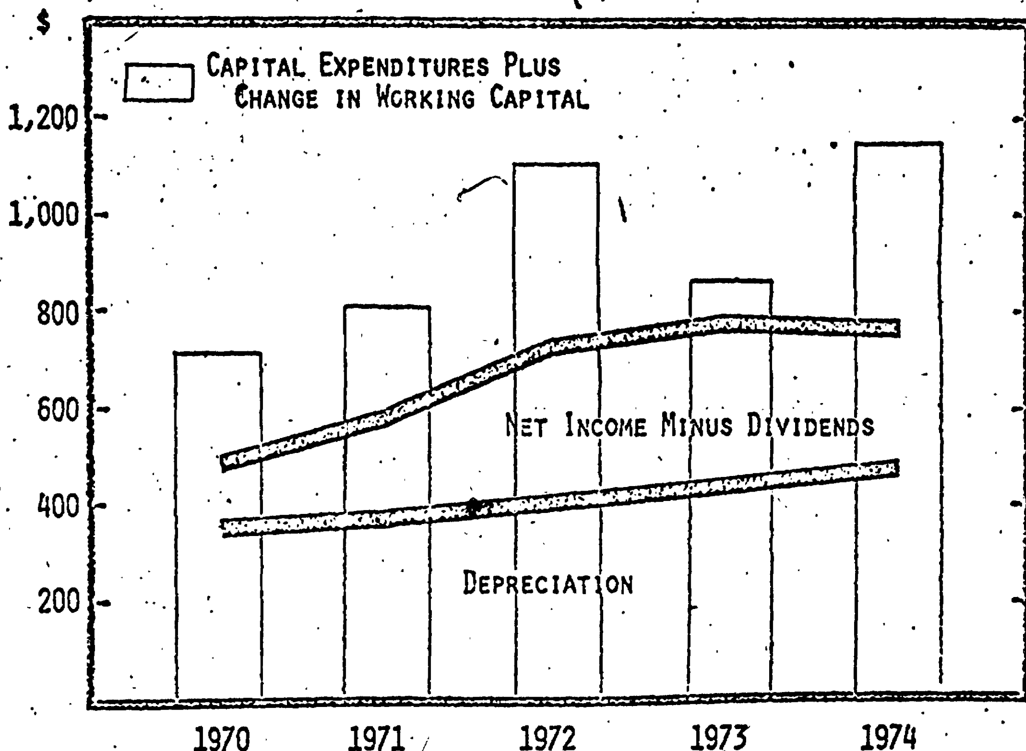
[1] "The Tire and Rubber Industry Debt Quality Study," February 1976.

[2] For two non-tire rubber manufacturing companies included in the Paine Webber study the change was from an average of 61.7 percent in 1965 to 196.5 percent in 1974.

Since 1970 three companies have gone out of the tire manufacturing business including one major tire company long in the field. The latter decided the cost of shifting to radial tire production could not be justified in terms of foreseeable return on the amount of new investment required and decided if it could not make the most advanced product it preferred to make none at all.



The shift to greater radial tire production is still in progress. It is a technological change not easily managed. Althogether new and expensive tire-building machines are necessary, more material is required per tire, the labor input is 20 to 40% higher per tire, the amount of floor space required is four-times greater per machine, and the machine itself turns out fewer tires per day. Bias-belted tires and even more so radial tires are at the same time more capital *and* more labor intensive than earlier generation tires. Having to implement these technological changes at a time when the costs of both labor and capital in the United States have risen to historic highs has imposed a severe strain on company profits.

In the rubber manufacturing industry hourly wages rose from an average of $2.75 per hour in 1963 to $4.72 per hour in 1974, an increase of 71.6%. During the same period the employee costs borne by rubber manufacturing companies for what were once called "fringe" benefits increased a staggering 300%, from an average $.99 per hour to $3.00 per hour. A listing of the specific benefits, by generic description, is attached on p. 9. Some ⅙th of these employee benefit costs have been imposed by law, but the remaining ⅚ths have been negotiated or conferred. Among the latter benefits, it is noteworthy that costs for "pensions and other welfare" benefits in our industry increased 535% from 1963 to 1974.

This is of course a story not unique to our industry but experienced in virtually all of U.S. industry in the same period. According to official Commerce Department reports total employee compensation as a percentage of national income increased from 68.1% in 1966 to 74.3% in 1975, showing a nearly constant

progression throughout the period. Over the same period corporate profits before taxes, adjusted for inventory price changes, declined from 13.3% of national income to 8.5% of national income in 1975. It is not surprising that tire manufacturing companies, together with other segments of U.S. industry, have been able in recent years to finance very few technological transitions satisfactorily out of retained earnings from profits, or new equity funds attracted by prospective profits.

COST ITEMS INCLUDED IN CENTS PER HOUR COST OF EMPLOYEE BENEFITS—1974—THE RUBBER MANUFACTURING INDUSTRY

(Production and Maintenance Wage Employees Only)

A. LEGALLY REQUIRED BENEFITS

1. Social Security (F.I.C.A.).
2. Unemployment Compensation.
3. Workmen's Compensation.
4. State Disability Insurance.
5. Voting Time.

B. VOLUNTARY OR NEGOTIATED BENEFITS

1. Insurance

(a) Hospitalization, Surgical-Medical, Prescription Drugs.
(b) Sickness & Accident—coverage in excess of legal requirements.
(c) Group Life Insurance (including Accidental Death & Dismemberment).
(d) Survivor Income Benefits.
(e) Workmen's Compensation Make-up Pay.

2. Pensions and Other Welfare Benefits

(a) Pensions (include profit-sharing plans only when payable on retirement).
(b) Severance Pay, Service Award, Termination Pay.
(c) Supplemental Unemployment Benefits.

3. Overtime Premium Pay

4. Shift Bonus

5. Time Paid For Not Worked

(a) Pay for Holidays Not Worked.
(b) Vacation Pay.
(c) Jury Pay.
(d) Funeral Pay.
(e) Pay For Grievance Time.
(f) Military Leave Make-up Pay.
(g) Bonuses or Gifts (lump sum payments not reportable as straight time earnings).

6. Miscellaneous Benefits

(a) Pail Lunch Period.
(b) Paid Rest Period.
(c) Paid Wash-up Time.

Nor has the other source of self-generated funds, depreciation allowances, been sufficient to fill the gap. Let me give you a set of illustrative figures from our industry. One of our tire manufacturing companies, the one with the lowest current ratio of debt-to-equity (which means that in past years it has been among those mosts able or determined to finance capital investments out of self-generated funds or new equity issues) in 1964 undertook $72,000,000 of capital improvements. In that year because it had $48,000,000 of additions to retained earnings and generated $54,000,000 in depreciation reserves it could finance the 1964 improvements internally. In 1974 the same company spent $320,000,000 for capital improvements, but the combined total of its additions to retained earnings ($96,000,000) and to the depreciation account ($136,000,000) totaled only $232,000,000 or some $88,000,000 short of its needs. For this company, 1974 has not been an unusual year. Over the 1964–1974 period this

company's total debt burden has increased by as large a percentage as the industry average (400%), while its increase in stockholders equity has followed the industry average (200%). In short, there are no companies in our industry which have escaped the need to finance technological change through heavy increases in corporate debt.

Practical consequences

The most important question for this Committee of course is not where tire manufacturers are today, but where they are going from here. Can tire manufacturers continue to finance necessary investment through further increases in debt? Are there harmful consequences ahead for the industry and for the consumers of its products unless corporate tax reform legislation occurs?

Our answer is that many companies have already hit the practical ceiling on corporate debt, and others will soon, and that present and foreseeable investment demands on our industry of a heavy nature cannot be financed in general by further debt increases. The Paine Webber study I mentioned earlier states:

"During the last decade, the trend of protective ratios for bondholders of the tire and rubber companies indicates a serious decline in the quality of debt . . . The debt burdens have been enlarged principally due to the advent of the bias belted tire, closely followed by the radial tires, both necessitating substantial capital expenditures as the tire manufacturers converted to new productive capability and increased inventory financing requirements. Rapidly changing technology in the tire industry has required large expenditures for research and development as well as for product implementation . . .

"Since 1965 two major companies have been downgraded at least once by one or both of the rating agencies. Nonetheless, of the five largest industry participants, three still appear vulnerable to downgrading, one is holding its own, and only the remaining one appears to be an improving credit."

The practical consequences of this debt ceiling are many: completion of the industry's shift to radial tires, particularly to radial truck tires, will be and is being delayed; the industry's possible contributions, as a result, to increasing employment in the United States at this time are far less than what they might be; the U.S. deficit trade balance in tires will continue, and new technological change, were it to occur, may find the industry highly vulnerable to major inroads in the U.S. market by foreign competitors; and lastly, non-productive but socially important investments, to reduce U.S. energy dependency on foreign oil, or undertake environmental or worker safety improvements, may be manageable if investments of magnitude are required. I would like to expand briefly on some of these practical consequences of the "capital shortage" in our industry.

Capital investments to produce radial tires have been concentrated by our companies to date in the production of radial passenger tires. Not only is the necessary investment in this product line still incomplete, but major investments have not yet occurred to achieve substantial production of radial truck tires. The market demand for truck radials is unquestionably strong, and is presently being served largely by foreign manufacturers.

The new productive capacity of U.S. manufacturers in passenger radial tires should help substantially to reduce the U.S. deficit trade balance in tires (which in 1973 reached $410 million in unmounted passenger and truck tires, predominantly radial). But for U.S. companies to complete the transition to passenger radials and enter the truck radial tire field in a large way will require heavy additional capital investments. Present corporate debt burdens do not allow additional investments of this magnitude to be made at this time. We are presently of course in a period of industry recession, and retrenchment has been dictated by a number of factors, of which the present size of corporate debt is clearly a major element. But postsponement of additional debt would be pursued by most of our companies even in the absence of the present recession. All industries whose capital demands have for a substantial period exceeded their ability to generate internal investment funds must eventually encounter a genuine ceiling on corporate debt. Once the ceiling is reached there must be a slowdown or abandonment of further projects.

A matter of very great importance for this Committee's deliberation is that substantial non-productive investment demands are confronting all manufac-

turing companies and either have been or may be imposed shortly through law or agency regulation. I refer among other things to the expensive tasks of converting natural gas and oil-fueled powerplants to coal, attaining stringent air and water purity environmental objectives, and reducing industrial noise levels thru plant engineering to 90 dBA.

By official government estimates the latter goal, in the process of being mandated by OSHA, will cost the rubber manufacturing industry $500 million over a three-year period. We are also faced with important investment demands to comply with the product regulation standards of an increasing number and variety of agency rules. Looking upon the tire manufacturing industry as a reasonably typical U.S. manufacturing industry, we can no longer respond affirmatively to all of the accumulated investment needs and demands being placed upon us. Congress must take timely action now to reverse investment-depressing financial trends its laws have set in motion or there will necessarily be grave economic and social consequences for the entire country.

Recommendations regarding capital formation reform

In regard to specific recommendations for corporate tax reform, I am impressed that there are many constructive proposals that have been put forward by the Administration, the U.S. Chamber of Commerce, the NAM, and others. Without detracting from the many excellent suggestions offered, I would like to comment on the urgent need for major tax reform in three areas in particular: the need for more adequate allowance for depreciation, the need to eliminate double taxation of dividends, and the necessity for special investment incentives for sometime to come.

Depreciation allowance

The arbitrary "useful life" concept of plant and machinery, despite Internal Revenue Code modifications in 1954 and 1971, has continued to govern the U.S. tax approach to depreciation allowances and has been a disastrous burden for American business and for the U.S. economy over the years.

The cash flow generated by this concept has sharply depressed U.S. investment levels since: (1) the concept fails to allow for inflationary price movements and as a result basically provides a level of reserves inadequate for replacing worn-out machinery, let alone financing new capacity; (2) the concept likewise fails to take adequate account of the factor of rapid technological change, which causes plant and machinery to become obsolete more quickly than originally expected; and (3) the system fails to match the accelerated depreciation allowances of our principal competitor nations, placing American business in a more and more disadvantaged position over time from which to maintain the edge in technology and productivity necessary if we are to shoulder the higher cost of labor in the United States yet remain internationally competitive. The NAM has urged adoption of an optional 5-year depreciation period for machinery, and 10-year period for plants. Regrettably this proposal would still leave U.S. companies at a disadvantage vis-a-vis their major foreign competitors. Although the proposed reform is too modest, we endorse it as an important step in the right direction. We would also urge an optional one-year write off period for pollution control and government-mandated investments generally.

Double taxation of dividends

Secretary Simon has ably expanded on the harmful distorting consequences on corporate finance produced by our system of double taxation of corporate dividends at high tax rates both for corporations and individuals. The effects have been a drying up of traditional sources of equity risk capital, an intensification of the pressure on corporations in recent years to pursue mergers and acquisitions in pursuant of vanishing levels of profitability, and a dangerous drift into ever higher levels of corporate debt to finance necessary capital improvement programs. Our double taxation system is clearly punitive toward stockholder investment capital, discourages savings and long term investment, and through forcing debt financing of new plant and equipment has produced over the past 10 years an increasingly dangerous degree of financial instability among U.S. corporations.

To correct these evils, and because as a practical matter American companies cannot continue financing capital improvements through debt, we strongly endorse

a phasing out of the double taxation of dividends as proposed by the Administration.

Special investment incentives

It would be comforting if Congress could institute corporate tax reforms restoring basic health and sanity to the financing of our further economic growth and allow these reforms to operate gradually. Unfortunately, there is too much that needs undoing to pursue a leisurely course. A high level of investment activity in new plant and equipment is necessary to exist from the present recession, to restore industrial employment levels to normalcy, to prevent further inroads by foreign companies in the domestic market of U.S. manufacturers, restore the U.S. technological lead and rate of productivity growth in numerous industrial areas, and permit the country to carry out national programs to expensive social objectives. Those who think these objectives can be achieved without major changes in U.S. tax laws to stimulate and reward investment and provide the necessary investment funds are greatly mistaken. Moreover, for some time a stimulus to investment activity alone and beyond merely balanced tax laws will be necessary. For this reason, we strongly endorse proposals to increase the investment tax credit to 12%, applicable on an expenditure basis without limitations on tax liability, and endorse other proposals deliberately designed to overcome the accumulated effects of a long investment-depressing period.

FOREIGN SOURCE INCOME

Another subject of great importance to RMA members before the Committee in this time is the tax treatment of foreign source income. Some of the more radical and less informed advocates of change in this area would go so far as to impose a punitive system of double taxation on the foreign earnings of U.S. multinational corporations by repealing the foreign tax credit. The bill passed by the House, H.R. 10612, wisely does not repeal the foreign tax credit nor tax deferral on the income of overseas subsidiaries of U.S. corporations, but would, inter alia, (1) substantially restrict the right to defer payment of income taxes on 50% of DISC profits from export sales, limiting this right in the future to income on export sales in excess of 75% of average export sales during a base period, and (2) require grossing up dividends from LDC corporations to determine U.S. income and foreign tax credits.

I mentioned earlier that the capital formation and foreign source income subject-matters are actually inter-related. This is true because the existing foreign source income tax rules, including DISC rules of the last three years, while accomplishing their primary objectives, have also been extremely useful to U.S. corporations in providing them indirectly with cash funds critically needed for important domestic purposes, cash funds which would otherwise not have been available because of the low rate of capital recovery under U.S. corporate tax laws. The important domestic purposes I refer to have been to sustain corporate liquidity and carry on with U.S. investment programs. The tax deferment provisions in our existing foreign source income tax rules have served to increase U.S. exports and expendable U.S. income at the same time.

DISC rules should be retained

The export figures reported by Secretary Simon make out a convincing case for concluding that the 1971 tax rules for DISC corporations have clearly fulfilled their original Congressional objective: to stimulate U.S. exports and related investment in the U.S. Since the 50% deferral right is available only on conditions that involve use of 95% or more of the deferred income on export-related inventories, equipment, etc. it is difficult to take seriously the accusations by some that DISC rules have had no effect in stimulating U.S. exports. The figures clearly demonstrate otherwise and the intrinsic operation of DISC rules could have no other possible effect. There is no cause whatsoever to curtail this highly successful stimulus to U.S. exports. As Secretary Simon aptly stated:

"Any curtailment of DISC would be particularly unfortunate at this time, when the economy is in the midst of a recovery. It would increase our present problem of capital formation by raising the taxes on capital at a time when they should be lowered. It would hit hardest those companies who have been doing the most to help our export efforts. We shouldn't alter DISC until there is agreement in the multilateral trade negotiations concerning uniform rules for taxation of exports."

U.S. benefits from overseas subsidiaries

The carefully constructed U.S. tax rules generally governing the income of foreign subsidiaries of U.S. companies have been a target of misguided reformers for several years inspired by fallacious notions of how these rules work and their consequences for U.S. trade and employment. In December 1972 RMA published a statistical study on this subject for the years 1964–1971, entitled "The Role of Multinational Corporations in the Tire Manufacturing Industry." A statistical supplement was prepared in 1973. The conclusions of that study are as valid now as they were initially. Attached to my statement on pages 21 and 22 is an update through 1974 of two of the most important tables in the study.

Among the conclusions of the RMA study were:

(1) Foreign subsidiaries of U.S. tire manufacturers do not produce any significant volume of tires for the U.S. market. In 1971 for example, a typical year, imports from foreign subsidiaries constituted $\frac{6}{10}$ths of 1% of the U.S. replacement tire market. Only 1.3% of the total production of all U.S.-owned tire manufacturing plants abroad was shipped to the United States in that year. Foreign tire manufacturing subsidiaries have been established to serve overseas markets, not to displace U.S. production.

(2) The result of serving overseas markets through overseas tire manufacturing subsidiaries has not been a reduction in U.S. exports, but an increase in U.S. exports, consistent with the general link in many fields between U.S. exports and the presence abroad of U.S.-owned subsidiaries. Moreover, the growth of U.S.-owned overseas tire manufacturing plants has not been financed by a heavy outflow of U.S. capital. On the contrary, remittances to the U.S. of dividends, royalties and other income from abroad have vastly exceeded net capital outflows in each year. The U.S. balance of payments has benefitted handsomely from the establishment of overseas tire manufacturing facilities by U.S. companies and through the general operation of U.S. multinational tire companies. Our study concluded that in the reasonably typical year of 1971, for example, a positive contribution to the U.S. balance of payments of $347.7 million was made by the five U.S. multinational tire manufacturing companies. This has been the case in each of the last 10 years as Table II on p. 22 indicates.

(3) New investment by the multinational companies has not been titled towards their overseas facilities but towards domestic facilities, see Table I on p. 21. Throughout the ten year period studied, domestic investment was nearly 70% of total manufacturing investment. It is important to note that the net earnings from overseas operations helped to finance this new U.S. investment and the creation of jobs in the United States, not the other way around.

Certain bills offered in the Senate which would change U.S. tax rules on foreign source income, and in particular require payment of U.S. taxes on the current income of overseas subsidiaries without regard to whether such income has been remitted to the U.S. parent, are simply punitive proposals that make no sense from any rational standpoint. The existing rules are not only sound in principle but have made positive contributions to the overall interests of the United States in our balance of trade, our balance of payments, and U.S. employment. Elimination of deferral would unwisely increase the tax burden on U.S. corporations and drain this amount of corporate investment funds from U.S. investment projects. The House Ways & Means Committee has decided to study this question further. Its study should lead it to conclude that the existing deferral provisions are eminently sound and in U.S. interest.

LDC corporations

On one last point, we would like to state our objection to the provision in H.R. 10615 which would increase taxes on corporate income from Less Developed Country corporations. The House bill requires grossing up of dividends from this source and changes existing tax credit calculations. The present rules serve as a mild encouragement to investment in developing countries, in furtherance of national foreign policy and humanitarian objectives. The changes proposed would not only eliminate this mild incentive but, in combination with the higher risks present in LDC projects, would establish a disincentive to invest in countries with a great need for foreign capital to improve living standards. We believe these proposed changes are objectionable. They would strike at corporations that have invested in LDCs in good faith and at friendly countries which will continue for many years to need foreign seed capital for their economic progress. American business can, and has, provided this seed capital in moderate amounts on terms of mutual benefit to the United States and host countries. A continuation should be encouraged, not discouraged, and our existing tax rule maintained.

Table I

1965 - 1974
Annual New Manufacturing Investment in Plants
And Equipment of U. S. MNCs
In the Tire Manufacturing Industry
(Exclusive of New Acquisitions)

(U.S. $ - Millions)

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	10-year Average
U.S.A.	244.5	276.7	300.8	390.7	467.4	420.7	278.3	403.4	563.2	573.0	391.9
Foreign	100.0	141.6	121.3	141.3	185.8	141.3	216.3	266.0	245.8	275.6	183.5
Total	344.5	418.3	422.1	532.0	653.2	562.0	494.6	669.4	809.0	848.6	575.4

Dollar Volume of Manufacturing Investment Over 10-Year Period

U.S.A.	$3,918,700,000	Domestic Manufacturing Investment as % of total = 68%
Foreign	1,835,000,000	Foreign Manufacturing Investment as % of total = 32%
Total	$5,753,700,000	Domestic investment compared to foreign investment - more than double the amount invested in foreign facilities.

Table II

1965 - 1974
Effect on Balance of Payments Resulting from Multinational Corporation Manufacturing Operations in the American Tire Industry

(U.S. $ - Millions)

Receipts	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	10-year Average
Exports of Manufactured Products to Subsidiaries, Affiliates and Associates	153.1	162.6	156.8	154.4	139.5	167.8	178.2	201.8	228.2	340.4	188.3
To Others	119.0	120.5	99.1	105.5	118.2	118.1	116.2	126.6	141.0	205.7	125.0
Total Exports	272.1	283.1	255.9	259.9	257.7	285.9	294.4	328.4	369.2	546.1	313.3
Dividends, Royalties and Other Incomes	78.9	99.6	114.8	121.3	124.8	153.2	151.2	124.6	98.9	125.6	119.3
Total Receipts	351.0	382.7	370.7	381.2	382.5	439.1	445.6	453.0	468.1	671.7	432.6
Payments											
Imports of Manufactured Products	21.6	22.5	27.2	46.5	51.3	71.9	69.7	93.3	151.3	180.1	73.5
Net Capital Outflows	37.6	12.8	31.9	9.8	4.9	15.0	28.2	22.9	25.7	45.8	23.5
Total Payments	59.0	35.3	59.1	56.3	56.2	86.9	97.9	116.2	177.0	225.9	97.0
Balance of Payments - Favorable	292.0	347.4	311.6	324.9	326.3	352.2	347.7	336.8	291.1	445.8	335.6

10-year total favorable balance of payments - $3,335,600,000.00

Senator BYRD. Thank you very much. The next witness will be Mr. J. B. Perkins, president, National Machine Tool Builders' Association.

Your statement will be printed in full in the record and you may summarize it if you wish.

STATEMENT OF J. B. PERKINS, PRESIDENT, HILL ACME COMPANY, CLEVELAND, OHIO, ACCOMPANIED BY JAMES A. GRAY, EXECUTIVE VICE PRESIDENT, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION, AND JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NMTBA

Mr. PERKINS. Senator Byrd, as you mentioned, my name is J. B. Perkins. I am president of the Hill Acme Company with its principal office and plant in Cleveland, Ohio.

Mr. James A. Gray, Executive Vice President of the National Machine Tool Builders' Association, NMTBA, and James H. Mack, Public Affairs Director, are appearing with me today.

The NMTBA, of which I am president, is a national trade association with about 360 members accounting for about 90 percent of the U.S. machine tool production.

You will note from the copy of the chart attached to my statement, exhibit C, that it illustrates in the most dramatic way the close correlation between domestic machine tool orders and the availability of the investment credit and the depreciation allowances of the ADR system.

Recent surveys disclose that once again the United States has the highest percentage of overage and obsolete machine tools, and the lowest percentage of the machine tools under 10 years of age, of any of the industrial nations.

Other nations, in patterning their industrial growth after the United States, have learned the simple rule of economics that the United States once knew so well, but somewhat inexplicably seems to have forgotten.

No government can or should expect business to invest in production facilities if the after-tax is so great and the cost recovery period so long and uncertain that business has no assurance of recouping its cost and realizing a reasonable return on its investment.

The temporary investment credit which has been on and off the books since 1961, and is due to expire in 1976, will not induce or secure the requisite investment.

The after-tax cost and risk are simply too great. Business has no assurance of adequate writeoffs for longer range projects and investments.

Only with an increased, permanent credit and a liberalized ADR that will make U.S. tax allowances comparable to those of other lead-

ing industrial nations can the United States attain the requisite productivity to be competitive.

Therefore, NMTBA makes the following recommendations:

1. The investment credit should be continued as a permanent part of our tax structure, and the rate should be increased to 15 percent.

If it is to be effective in encouraging major longer range acquisitions and projects, it must be extended beyond 1976, and taxpayers must have assurance of its availability with a fixed rate for a minimum of five years.

2. The additional first-year allowance provided in Section 197, which is no more than a token allowance, should be continued with an increase in the $10,000 ceiling to $100,000.

3. The accelerated methods, declining balance and the sum-of-the-years-digits, should be retain to recognize the greater loss of value in the early years of use.

4. The ADR system should be continued in a greatly simplified form with an increase in the 20 percent optional variation in guideline lives to the 40 percent proposed in 1970 by the President's Task Force on Business Taxation.

An increase to 40 percent is required to make the depreciation allowance of the ADR comparable to the capital recovery allowances in other nations. The 40-percent liberalization would permit a writeoff of machine tools in approximately seven years. This is entirely reasonable in the light of the greatly accelerated technological obsolescence in machine tools.

Simplification of the ADR is required because the present complexity of the ADR and the substantial expense involved in its application have discouraged too many companies, particularly small companies, from adopting the ADR.

5. Along with these adjustments to the ADR, Congress should also reconsider the traditional and controversial depreciation concepts which gave rise to the complexity in the ADR, and the advisability of substituting for them a standardized capital recovery allowance.

Legislation along the lines of H.R. 8226, recently introduced by Congressman Waggonner of the House Ways and Means Committee, would provide the kind of system and allowances that would assure the investment required to make the United States fully competitive with other industrial nations.

The writeoff period for machinery and equipment should be no longer than 20 to 25 years.

6. To facilitate compliance by small businesses with pollution control standards and the requirements of OSHA, we urge more realistic tax treatment of equipment purchased to comply with these requirements, in the form of a 1-year writeoff of such equipment.

The NMTBA shares the national concern with pollution control, and has always been deeply concerned with the health and safety of

However, it must be recognized that the equipment necessary to adhere to these aims is expensive, and places a substantial burden to small businesses, since it contributes nothing to productivity or increased earnings.

We therefore support the proposal of Congressman Steiger now under consideration by the Ways and Means Committee Task Force on Capital Formation for a 1-year writeoff of equipment purchased to comply with OSHA, and believe that a similar provision should be adopted with regard to pollution control facilities.

7. The Domestic International Sales Corporation, DISC, provisions, sections 991-997, should be retained in the Internal Revenue Code.

The continuance of DISC is tremendously important to the relatively small companies in the machine tool industry. They have relied on cash flow provided by the DISC to increase domestic investment so as to compete more effectively in foreign markets.

Export shipments of machine tools increased from $267.6 million in 1971, the year the DISC was enacted, to $567.6 million in 1975. In the case of my own small company, DISC helped to triple our export sales—from $2.46 million in 1971 to $7.45 million in 1975.

At a time when employment is down and investment capital in short supply, our balance of trade would be seriously undermined by repeal of the DISC.

This would have the effect of greatly reducing the export business of hundreds of companies, many of them small companies in the machine tool industry, and thus reducing U.S. jobs and the U.S. balance of trade.

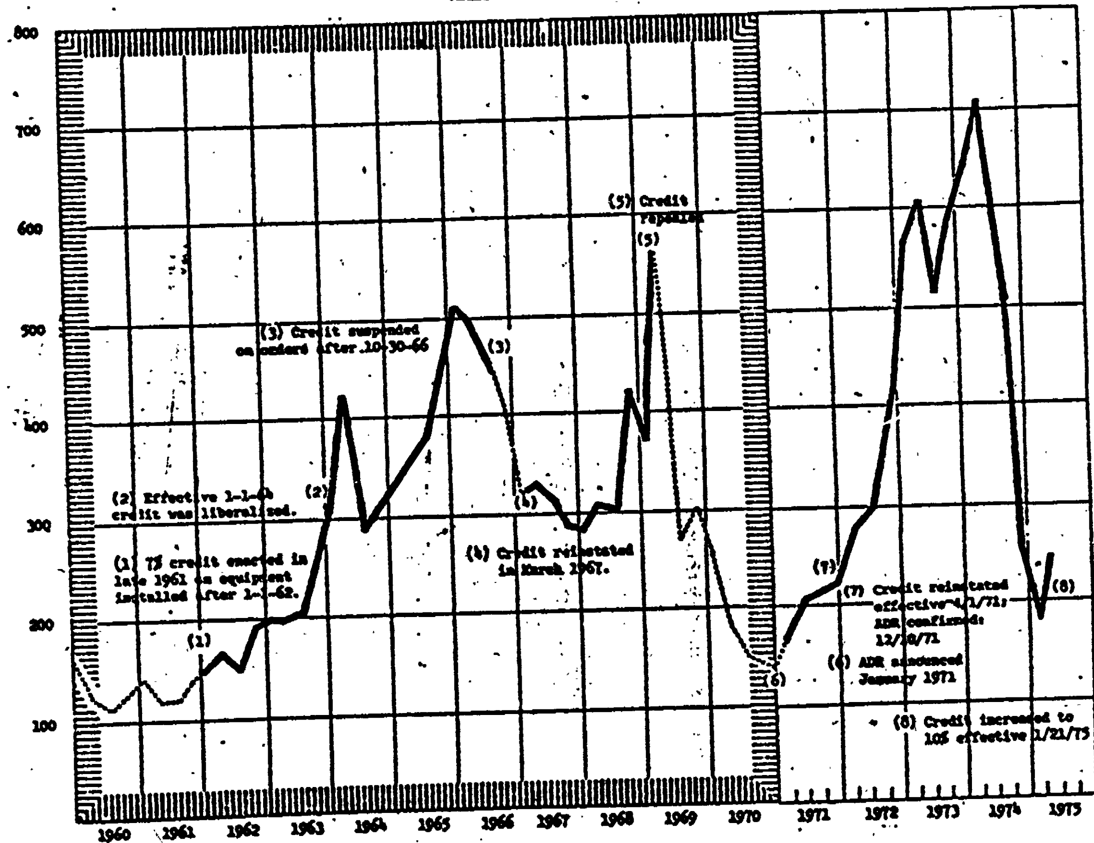
Application of a base period concept to DISC sales penalizes those companies which have worked hardest to build up their foreign export sales during that period, thereby helping to bolster the sagging domestic economy and maintain employment during the recession period. Although the enactment of a five-year "grace period" between changes in base period would mitigate slightly the tremendous burden placed on small companies, the overall effect of the "base period" approach would be to seriously hamper the ability of small businesses to compete in international trade at a time when domestic orders are still very lean.

8. Taxation of foreign-source income should not be increased by such measures as annual taxation of the income of controlled foreign corporations or repeal or drastic limitation of the foreign tax credit.

We are grateful for this opportunity to present the industry's views on the urgent need for tax revision to encourage capital formation and modernization of industrial facilities.

[The chart attached to Mr. Perkins' prepared testimony follows:]

MACHINE TOOLS - Domestic New Orders



Senator BYRD. Thank you, Mr. Perkins.
Senator Curtis.

Senator CURTIS. Mr. Chairman, I want to thank the witness for providing some very helpful information.

I would like to ask whether you feel that the asset depreciation range—the ADR—is of substantial and practical value to you?

Mr. PERKINS. Yes; of course it is. I don't think it is anywhere near large enough. It does have a disadvantage for some small companies because of its complexity. Consequently, a great many small companies do not use them. I think there is a considerably better way. I am not an accountant but I believe the same benefit can be arrived at in a much simpler way.

Senator CURTIS. As I have mentioned on previous occasions during these hearings, this committee will not be the sole body to determine what will be done in the field of taxation. We anticipate a considerable debate and fight on the Senate floor over whatever we produce here.

The distinguished Senator from Massachusetts, Senater Kennedy, is leading the efforts for the further taxing of many phases of business. He advocated the repeal of the ADR when he apeared before this committee.

It is your recommendation that ADR definitely should be retained, but we should make efforts to simplify it and put it within the reach of all taxpayers?

Mr. PERKINS. And it should be increased to 40 percent. One way or the other, a company should be able to accelerate its depreciation now.

Senator CURTIS. That is all, Mr. Chairman.

Senator BYRD. Senator Hansen.

Senator HANSEN. I have no questions. Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Perkins.

[The prepared statement of Mr. Perkin's follows:]

BRIEF SUMMARY OF RECOMMENDATIONS OF NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

1. The investment credit should be continued as a permanent part of our tax structure, and the rate should be increased to 15 percent. If it is to be effective in encouraging major longer range acquisitions and projects, it must be extended beyond 1977, and taxpayers must have assurance of its availability with a fixed rate.

2. The additional first-year allowance provided in Section 179, which is no more than a token allowance (20% of $10,000 or $2,000), should be continued with an increase in the $10,000 ceiling to $100,000. A first-year allowance of up to $20,000 (20 percent of $100,000) is required if the allowance is to be meaningful and really helpful to small business as intended. Many small companies today to stay competitive must acquire technologically advanced machine tools costing $100,000 and even as much as $500,000. The cost is often the equivalent of the net worth of the company.

3. The accelerated methods ("declining balance" and "sum-of-the-years-digits") should be retained to recognize the greater loss of value in the early years of use.

4. The ADR system should be continued in a greatly simplified form with an increase in the 20 percent optional variation in guideline lives to the 40 percent proposed in 1970 by the President's Task Force on Business Taxation. An increase to 40 percent is required to make the depreciation allowance of the ADR comparable to the capital recovery allowances in other nations. The 40 percent liberalization would permit a writeoff of machine tools in approximately seven years. This is entirely reasonable in the light of the greatly accelerated technological obsolescence in machine tools. Many advanced numerically con-

trolled machine tools of the most modern design in 1970 are obsolete just five years later in 1975. Simplification of the ADR is required because the present complexity of the ADR and the substantial expense involved in its application have discouraged too many companies, particularly small companies, from adopting the ADR. The complexity has actually resulted from the conscientious effort of Treasury officials to accommodate all the refinements of accounting theory and the generally accepted but controversial accounting principles as they apply to depreciation and the differentiation of expense and capital items. As Secretary Simon has well said, enough time has been devoted to accounting theories and controversies, and the time has now arrived "to come to grips" with realistic accounting as a substitute for "public relations bookkeeping."

5. Along with these adjustments to the ADR, Congress should also reconsider the traditional and controversial depreciation concepts which give rise to the complexity in the ADR, and the advisability of substituting for them a standardized capital recovery allowance. This new capital recovery system can be patterned after the Canadian system and similar systems of other countries. Legislation along the lines of H.R. 8226, recently introduced by Congressman Waggonner would provide the kind of system and allowances that would assure the investment required to make the United States fully competitive with other industrial nations. The writeoff period for machinery and equipment should be no longer than five to seven years, and for buildings no longer than 20 to 25 years.

6. To facilitate compliance by small businesses with pollution control standards and the requirements of OSHA, we urge more realistic tax treatment of equipment purchased to comply with these requirements, in the form of a one year write-off of such equipment. The NMTBA shares the national concern with pollution control, and has always been deeply concerned with the health and safety of the workers producing and operating machine tools. However, it must be recognized that the equipment necessary to adhere to these aims is expensive, and places a substantial burden on small businesses, since it contributes nothing to productivity or increased earnings. We therefore support the proposal of Congressman Steiger now under consideration by the Ways and Means Committee Task Force on Capital Formation for a one year write-off of equipment purchased to comply with OSHA, and believe that a similar provision should be adopted with regard to pollution control facilities.

7. The Domestic International Sales Corporation (DISC) provisions (Section 991–997) should be retained without change in the Internal Revenue Code. The continuance of DISC is tremendously important to the relatively small companies in the machine tool industry. Many of these companies because of capital shortages cannot make the investment in plant facilities abroad because of capital shortages there to supply their foreign markets. They have relied on cash flow provided by the DISC to increase domestic investment so as to compete more effectively in foreign markets. The result has been a substantial increase in machine tool exports since the adoption of the DISC.

Export shipments of machine tools increased from $267.6 million in 1971 (the year the DISC was enacted) to $567.6 million in 1975.

At a time when employment is down and investment capital in short supply, our balance of trade would be seriously undermined by repeal of the DISC. This would have the effect of greatly reducing the export business of hundreds of companies, many of them small companies in the machine tool industry, and thus reducing U.S. jobs and the U.S. balance of trade.

Application of a "base period" concept to DISC sales penalized those companies which have worked hardest to build up their foreign export sales during that period, thereby helping to bolster the sagging domestic economy and maintain employment during the recession period. Although the enactment of a five year "grace period" between changes in base period would mitigate slightly the tremendous burden placed on small companies, the overall effect of the "base period" approach would be to seriously hamper the ability of small businesses to compete in international trade at a time when domestic orders are still very lean.

8. Taxation of Foreign Source Income should not be increased by such measures as annual taxation of the income of controlled foreign corporations or repeal drastic limitations of the foreign tax credit. Such changes would seriously undermine the ability of U.S. corporations to do business abroad. No other country imposes such serious tax penalties on foreign operations, and indeed many countries not only provide substantial tax benefits, but may also directly subsidize the foreign operations of their national corporations.

The loss of international markets to our foreign competitors would have a drastic effect on our national economy and defense capability. U.S. Government and other surveys have shown that there is clearly a net benefit from foreign operations, and that they have contributed tremendously to the increase in industrial plants and jobs in the United States. The 1972 Department of Commerce study of multinational corporations estimates that more than 500,000 jobs would be lost if there were no U.S. foreign direct investment. The study concluded that 250,000 employees, principally production workers, would be out of work; that another 250,000 jobs would be eliminated in the home offices of U.S. multinational companies; and that an additional 100,000 jobs for supporting workers would also be lost.

Statement of National Machine Tool Builders' Association

My name is J. B. Perkins. I am President of the Hill-Acme Company with its principal office and plant in Cleveland, Ohio.

Mr. James A. Gray, Executive Vice President of the National Machine Tool Builders' Association (NMTBA) is appearing with me today.[1]

The NMTBA is a national trade association with 360 members accounting for about 90 percent of the United States' machine tool production.

Most of the member companies are small businessmen. Over 70 percent of these companies have less than 250 employees. The entire industry has approximately 90,000 employees.

We are grateful for this opportunity to present the industry's views on the urgent need for tax revision to encourage capital formation and modernization of industrial facilities.

Although we have begun to make some progress, high unemployment and inflation continue to plague the health of our national economy. To insure the investment and capital formation necessary for economic growth, for the creation of new jobs, and to remain competitive with other nations, we must revise our present tax structure to insure that sufficient after-tax earnings will be available for investment, and change the disincentives under present tax law into incentives for future investment.

We endorse wholeheartedly the views expressed to this Committee on March 17, 1976, by Secretary of the Treasury William Simon on the need for tax revision to remove the bias against capital formation and investment in industrial facilities. Secretary Simon's clear and forthright exposition of the adverse economic effects of the present tax structure should dispel some of the erroneous notions about the role of capital investment and profits in providing jobs and a high standard of living.

THE NEED FOR INCREASED INVESTMENT: U.S. INDUSTRY IS LOSING ITS COMPETITIVE POSITION

The machine tool industry is small, but essential to the productivity of all United States industry. All metal products from automobiles to armaments are made on machine tools, including machine tools themselves, and the governments of the principal industrial nations are now well aware how vital this industry is in peace and war. They have now moved ahead of the United States in adopting tax and other policies to encourage investment in machine tools to modernize their plants, increase their productivity, and increase their share of the world market. Unless the United States takes similar steps, it will lose its competitive position in international trade.

A recent U.S. Commerce Department survey[2] and the American Machinist's 11th Metalworking Equipment Inventory disclose that once again the United States has the highest percentage of overage and obsolete machine tools, and the lowest percentage of machine tools under 10 years of age, of any of the industrial nations. Not only does the Soviet Union have a higher percentage of machine tools under 10 years old (57%) as compared with the United States

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[1] It will not be possible in the time allotted to present this statement in full. Accordingly, we request that the statement and the accompanying exhibits be included in the record of the hearing.

[2] American Machinist 11th Inventory and U.S. Department of Commerce, Global Market Survey—Metalworking and Finishing Equipment, January 1975. The United States has a lower percentage (33 percent) of machine tools under 10 years old than Japan (70 percent), West Germany (63 percent), Italy (50 percent) and the United Kingdom (41 percent).

(33%), but the total number of machine tools in the Soviet Union (4.4 million) is now greater than the number in the United States (3.8 million).[3]

The U.S. machine tool industry has only recently resumed its position as world leader in the production of machine tools after several years of being second to West Germany, followed closely by the Soviet Union and Japan.[4] The United States is still the leader in engineering and design, and in the production of the most technologically advanced machine tools, but the gap is constantly narrowing.

Probably the most significant statistic and the one that has the clearest warning for the United States in terms of its industrial and defense capability is the comparison of the consumption of machine tools in the leading industrial nations. This is an important indictaor of industrial growth and technological advancement. The Soviet Union has recently moved into second place almost even with the United States in the consumption of machine tools with Japan and West Germany third and fourth.[5] For a time the Soviet Union was in first place, and its present and projected rate of increase suggests that it may once again lead in the consumption of machine tools if U.S. capital investment continues to lag.[6]

All of the industrial nations in the western world have a higher rate of capital formation in relation to GNP than the United States. (See Exhibit E.)[7]

All of these nations have a higher rate of increase in productivity than the United States. (See chart attached as Exhibit F.)

This, of course, accounts for the higher level of obsolescence in U.S. industry already referred to. For the first time since the depression-ridden 1930's the rate of productivity improvement in the United States showed a decline of 2.7% from 1973 to 1974.[8]

And finally, the United States has the lowest tax allowances for capital costs of any of the leading industrial nations.[9]

THE BASIC CASE FOR LIBERALIZED CAPITAL COST RECOVERY

These other nations, in patterning their industrial growth after the United States, have learned the simple rule of economics that the United States once knew so well, but somewhat inexplicably seem to have forgotten: no government can or should expect business to invest in production facilities if the after-tax cost is so great and the cost recovery period so long and uncertain that business has no assurance of recouping its cost and realizing a reasonable return on its investment.

The necessity for determining and reporting income and the cost of producing it on an annual basis does not alter the fact that in a very real sense there is no profit, no assurance of profit, nothing but risk until the cost is completely written off against income. And a persuasive case has been made by a number of distinguished economists for a full writeoff in the first year.[10]

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[3] See also page 1008 of American Machinist 11th Metalworking Equipment Inventory attached hereto as Exhibit H setting out data based on statistics for mid-1973.

[4] 1975 machine tool production figures, provided by American Machinist: United States, $2,480,000,000; West Germany, $2,344,900,000; Soviet Union, $1,963,800,000; Japan, $1,089,000,000.

[5] Consumption of machine tools (1975): United States, $2,285.1 million; Soviet Union, $2,284.4 million; Japan, $930.7 million; West Germany, $755.5 million. 1975 figures provided by American Machinist (Jan. 14, 1976).

[6] Net new orders for 1975 were only 1,186,350,000, a decline of 53 percent from the 1974 figure.

[7] Figures are not available for the Soviet Union.

[8] David L. Babson Staff Letter, June 26, 1975, p. 3.

[9] Comparative analyses of the aggregate cost recoveries allowable for tax purposes in the United States and other industrial nations make it clear that the United States still lags behind. See attached chart marked Exhibit G.

Some comparative analyses based solely upon the statutory provisions in the various countries present the United States investment recovery provisions much more favorably than is warranted in comparison to those of other industrial nations. Some of these comparisons show that the United States does not have the lowest statutory allowances. But this is misleading and inaccurate.

In other countries, tax administration is very flexible, and more liberal recovery allowances are actually allowed in administrative practice than the written law would appear to allow, or are allowed in the United States.

[10] This is in effect the result under the consumption-type value-added tax (VAT) used so effectively by other industrial nations to discourage high-cost operations and encourage facility investment. All of the nations in the European Economic Community have adopted the VAT which by taxing costs encourages low-cost production. In contrast, the income tax encourages high-cost production because it taxes income, thus imposing a penalty on efficiency and low-cost production.

Unfortunately, under our tax system, the after-tax cost has been so great, the cost recovery periods so long, and the constant threat of adverse legislation so fraught with uncertainties, that business has not been able to assume this risk, or to plan or invest adequately to increase productivity as required.

CAPITAL RECOVERY TAX PROVISIONS: NEEDED CHANGES IN DEPRECIATION AND THE INVESTMENT CREDIT

Economists and the Government have come to recognize that the small but essential machine tool industry is a most reliable barometer for measuring the economic health of the nation, and for determining the impact and effect on industry of changes in the capital recovery tax provisions—depreciation and the investment credit.

This was recognized by the Finance Committee in its Report on the Revenue Act of 1971 (Report No. 92-437, pp. 8 and 9), in which it included the chart submitted by the NMTBA in the 1971 Committee hearings. This chart showed very dramatically the impact of tax allowances on quarterly domestic machine tool orders from 1960 through 1970. At pages 8-9 the Committee stated:[11]

The new [investment] credit is expected to bolster the economy and create additional jobs by encouraging expenditures on machinery and equipment which have been sagging badly. *In this connection, attention is called to the following chart which shows the close correlation between machinery orders and availability of the investment credit.*

Moreover, over the long run, the job development [investment] credit will be of material assistance in combating inflation. An increased flow of goods into the market is the best long-run assurance we can have of keeping prices down.

Finally, by making our productive facilities more efficient the new credit will help our exporters to compete for foreign markets and improve our balance of payments." (Emphasis added)

No more effective or concise statement could be made of the need for the investment credit in 1971, and it applies with equal force today.

As the Committee predicted, the 7 percent credit did bolster the economy by increasing jobs, productivity and exports from 1971 to 1974. Our revision of the chart (Exhibit C) updated through the fourth quarter of 1975 illustrates in the most dramatic way for the years 1971-1973 (as it does for the years 1960-1971) the close correlation between domestic machine tool orders and the availability of the investment credit and the depreciation allowances of the ADR system.

The total annual machine tool shipments of the industry were estimated at $2,451,700,000 in 1975 as compared with $1,057,870,000 in 1971, the year the 7 percent investment credit was reinstated and the ADR system was adopted. Export shipments also increased from $267.6 million in 1971 to $467.6 million in 1975 due in large measure to the 1971 enactment of the investment credit, the Asset Depreciation Range (ADR) and the Domestic International Sales Corporation (DISC) tax provision beginning in 1971.[12]

We are also submitting a chart (marked Exhibit D) showing the relationship of employment to domestic orders measured in constant dollars in the industry for the period 1960-1975. When read in conjunction with Exhibit C, it indicates the positive effect that increasing capital recovery allowances has on jobs.

However, the investment credit finally could not offset the combined and cumulative effects of price controls, double-digit inflation, and the worst recession since the 1930's. A strong case can be made that the repeal of the investment credit in 1969 actually triggered and intensified the subsequent inflation, and that the 1971 credit and ADR came too late to prevent or effective moderate.[13]

Unfortunately, as the accompanying charts show (Exhibits A and B), the industry sustained substantial losses in 1971 and 1972 and extremely low levels of income in 1973, 1974 and 1975. This was principally a consequence of inflation

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[11] The NMTBA chart with the same favorable statement supporting the job development (investment) credit was included at pages 5 and 6 of the House Committee on Ways and Means Report (Report No. 92-533).

[12] As we shall point out later in this statement, the continuance of the favorable tax treatment of DISC is most important, particularly for the relatively small companies in the industry that cannot make plant investments abroad but must maintain and increase their exports to stay competitive at home and abroad.

[13] See attached NMTBA publication, "Inflation, Phantom Profits and Tax Bias," pp. 1, 13, 16, 17 and 21.

and government price control policies which had an unfair impact on the machine tool industry and other industries with long lead times from order date to delivery date, and has brought these industries full cycle once again to a renewed need for further tax policy change, for the reasons this Committee documented so well in its 1971 report.

PRICE CONTROLS AND INFLATION FINALLY NULLIFIED THE EFFECT OF THE TAX CREDIT IN 1974

You will note from Exhibit C the precipitous decline in orders beginning in 1974. At first glance this 1974 decline might seem to challenge the validity of the proposition, clearly supported by the chart for all the years beginning in 1960 through 1973, that investment in productive equipment depends on adequate capital recovery tax allowances, and that there is a close correlation between orders and the availability of these allowances.

Actually, the steep decline in 1974 orders that departs from the historical pattern can be readily explained by the intervening disastrous impact of another government policy—price controls—which deepened the recession. This unwise policy completely dominated the economy and almost completely dictated corporate decisions against further capital investment in 1974.

Somewhat paradoxically, this 1974 aberration actually serves upon analysis to bolster the position that orders and investment do depend on adequate capital cost allowances as the NMTBA chart had so clearly established for prior years.

As the chart shows, the momentum provided by the 7 percent credit and the ADR sustained orders and investment through the years 1971, 1972 and 1973 despite price controls and the resulting low profits and losses the capital goods industries were realizing all through this period. These orders finally plummeted as industry ran out of steam and capital due to the disastrous effects of price controls—unreasonably low prices and low profits, incredibly high interest rates, double-digit inflation, and the resulting critical shortages of raw material and components. It is clear that without increased capital cost allowances, new orders would have plummeted long before 1974.

Not only were price controls and inflation finally taking their toll in 1974 and making facility-investment impossible, but to compound the problem, many influential members of the Congress had been introducing bill after bill in the 93rd Congress to reduce and repeal the capital recovery allowances enacted in 1971.[14]

It was not a climate for long-range planning or investment. The on-and-off investment credit was under attack and the ADR system was constantly threatened with repeal as it still is today.[15]

THE INVESTMENT CREDIT AND ADR MUST BE MAINTAINED AND INCREASED TO INSURE ECONOMIC RECOVERY

It is significant to note that with the enactment of the 10 percent investment credit in 1975 following the termination of price controls in 1974, machine tool orders immediately increased. This would seem to be proof positive of the immediate stimulative effect of increased tax allowances on capital investment.

However, although the increase from 7 percent to 10 percent in the investment credit has quite clearly sparked an upturn in orders, it is a very small upturn indeed; and it starts from the second lowest level of new orders since 1961, when the investment credit was first proposed. Actually net new orders for 1975 declined 53% from 1974 levels. We cannot hope to improve the national economy without a much greater increase in industrial productivity than these figures indicate.

However, economic indicators show that it will take more than the present temporary 10 percent investment credit to sustain and improve the 1975 upturn. We must carefully examine and update those tax provisions which result in a bias against capital formation and industry growth.

To eliminate obsolescence and increase productivity sufficiently to make U.S. industry healthy and fully competitive, the ADR must be maintained and lib-

[14] 93d Congress: H.R. 967 and H.R. 8282 (Reuss and others); H.R. 1040 (Corman and others); H.R. 14390 (Adams); S. 1098 (Bible, Kennedy, McGovern); S. 1439 (Muskie).

[15] See similar bills introduced in 1975 in the 94th Congress such as S. 512 (Haskell); H.R. 2702 (Moakley); H.R. 6988 (Bonker); H.R. 1040, 1041 and 4371 (Corman).

eralized and the investment credit should be made a permanent part of our tax structure, with the rate increased to 15 percent. This Committee and the Senate very wisely recognized that a 10% credit is inadequate in approving a 12% rate for qualifying businesses in the Tax Reduction Act of 1975, H.R. 2166, 94th Cong., 1st Sess., passed by the Senate on March 22, 1975.

These changes are necessary for two reasons. First, world economic conditions have deteriorated in recent years due in large part to a slowed investment and productivity rate, a fact which has prompted other nations to increase once again their cost recovery allowances. They want to be sure to get the technologically advanced facilities that will overcome their spiraling material and labor costs; increase their productivity and their share of world markets. For example, Canada now permits the write-off of machinery and equipment in two years.

In view of our much higher labor costs, and our greater reliance on a progressive income tax that puts such a terrific penalty on efficient, low-cost production, capital cost tax allowances in the United States must be higher (instead of lower, as at present) than those of our foreign competitors if we are to have a comparable increase in investment and productivity.

The temporary investment credit which has been on and off the books since 1961, will not induce or secure the requisite investment.

The House, in adopting H.R. 10612, recognized this fact. As the House Ways and Means Committee Report on H.R. 10612[16] stated:

Since the beginning of 1975, investment plans have been repeatedly reduced, and planned expenditures in new plant and equipment are expected to be 10 percent lower in 1975 as compared to 1974. Because of the need to provide for the long-run growth potential in the economy, the need to provide greater certainty to investors about the availability of the credit in the future, and the need to provide a continuing stimulus to the economy, the 10-percent investment tax credit was extended four additional years.

We commend the House for its recognition of this critical situation and its action to extend the investment credit. However, while a four-year extension will be of some benefit in making possible more long-range planning so badly needed to solve the longer-range problems, we do not believe it goes far enough.

The after-tax cost and risk are simply too great. Business has no assurance or adequate writeoffs for longer range projects and investments. Only with an increased, permanent credit and a liberalized ADR that will make U.S. tax allowances comparable to those of the other leading industrial nations can the United States attain the requisite productivity to be competitive.

Second, an increase in the investment tax credit to 15% is necessary to counterbalance the effects of inflation. There are those who charge that such a provision would amount to a tax "subsidy" of business. That is far from the truth. Those who charge "subsidy" have the burden of proving that such a cost allowance is (1) not properly warranted to make up for the inadequate capital cost tax allowances of the past (the question is really only one of timing of the allowances), and (2) that it is in excess of the actual facility costs incurred over the period of use in producing the income taxed.

Obviously, they cannot sustain this burden. As a recent study entitled "Inflation and Profits" by George Terborgh, Economic Consultant to the Machinery and Allied Products Institute (1974) made clear, capital costs of producing income have been greatly understated for tax purposes year after year by reason of inflation.

This, together with the use of both prices and reported profits in response to inflationary conditions, has led to a corresponding rise in the income taxation of reported profits. Since these profits are greatly overstated, this has led to an effective federal tax rate on corporate profits of 61.5 percent over the past four years, and 73.9 percent in 1974.[17] This increased taxation prevents the accumulation of new capital, and actually results in taxation of capital itself. Secretary Simon, in his May 7 statement to the Senate Finance Committee,

[16] House Committee on Ways and Means, Rep. No. 94–658, 94th Cong., 1st Sess., 1975, at 187.

[17] See "Inflation and Profits" at 7.

reaffirmed these findings that corporate income has been very substantially overstated and overtaxed.

Not only have capital costs been understated and income overstated for tax purposes, but the same kind of cost understatement and income overstatement has occurred year after year for financial reporting purposes as a consequence of management's use of the unrealistic straight line method purposely to maximize earnings to gain access to the debt and equity markets. Actually it has been counter-productive, resulting in higher wage demands, higher costs and inadequate profits for capital investment. As Secretary Simon has pointed out, this completely indefensible "public relations bookkeeping" unfortunately has had the endorsement of many accountants (and the condemnation of others), and has intensified the erosion of profits and the shortages of capital for investment. It is a part of the vicious cycle that stems from inadequate tax allowances and overpaid taxes to begin with.

An increase in the investment credit would also help to reduce unemployment. It is axiomatic that workers cannot be productive without the tools of production, which are becoming increasingly expensive. We cannot hope to maintain, let alone expand, present employment without substantial investment in the machinery and equipment that form the basis of well-paying jobs.

THE ADR SHOULD BE LIBERALIZED AND SIMPLIFIED

The Asset Depreciation Range System, adopted in 1971 on the basis of a Treasury survey, encourages investment in new and technologically more advanced machinery and equipment necessary to increase productivity and provide new jobs. The ADR with its standardized lives is a vast improvement over the prior "useful or physical life" concept which has been thoroughly discredited and condemned by the 1960 Kennedy Administration and all subsequent Administrations. We fully support retention of the ADR system, and suggest that certain changes be made to make it less complex and more effective in encouraging economic growth and helping maintain U.S. leadership in world markets. While supporting the ADR system with its national basis, we also suggest that the time has come in light of U.S. capital needs and world competition to give careful consideration to the institution of a capital cost recovery system comparable to that in effect in other leading and competitor industrial nations.

In the meantime, we believe that the following changes in the ADR are necessary in light of changed economic conditions in the U.S. and the world since its adoption in 1971.

First, an increase in the 20 percent optional variation in guidelines, to the 40 percent proposed in 1970 by the President's Task Force on Business Taxation, is required to make the depreciation allowance of the ADR comparable to the recovery allowances in other nations. The 40 percent liberalization would permit a writeoff of machine tools in approximately seven years. This is entirely reasonable in the light of the greatly accelerated technological obsolescence in machine tools. Many advanced numerically controlled machine tools of the most modern design in 1970 became obsolete just five years later in 1975 and more are becoming obsolete in 1976. Furthermore, by the time these assets are depreciated and replaced, the cost of replacement has risen so greatly due to inflation that increased replacement costs must be paid for out of earnings or newly-invested capital. Second, simplification of the ADR is required because the present complexity of the ADR and the substantial expense involved in its application have discouraged too many companies, particularly small companies, from adopting the ADR. The complexity has actually resulted from the conscientious effort of Treasury officials to accommodate all the refinements of accounting theory and the generally accepted but controversial accounting principles as they apply to depreciation and the differentiation of expense and capital items.

As Secretary Simon has well said, enough time has been devoted to accounting theories and controversies, and the time has now arrived to "come to grips" with realistic accounting as a substitute for "public relations bookkeeping."

We also urge that while making these adjustments to the ADR, Congress also reconsider the traditional and controversial depreciation concepts[18] which give rise to the complexity in the ADR, and the advisability of substituting a standardized capital recovery allowance for the standardized depreciation allowances of the ADR. This new capital recovery system can be patterned after the Canadian system and similar systems of other countries. Legislation along the lines of H.R. 8226, introduced in 1975 by Congressman Waggonner would provide the kind of system and alowances that would assure the investment required to make the United States fully competitive with other industrial nations.

The writeoff period for machinery and equipment should be no longer than five to seven years, and for building no longer than twenty to twenty-five years.

ADDITIONAL FIRST YEAR DEPRECIATION ALLOWANCE

The additional first-year allowance provided in Section 179, which is no more than a token allowance (20 percent of $10,000 or $2,000), should be continued with an increase in the $10,000 ceiling to $100,000. A first year allowance of up to $20,000 (20 percent of $100,000) is required if the allowance is to be meaningful or recognize the first year loss of value, and really helpful to small business as intended. Many small companies today to stay competitive must acquire technological advanced machine tools costing $100,000 and even as much as $500,000. The cost is often the equivalent of the net worth of the company.

ACCELERATED DEDUCTION METHODS SHOULD BE RETAINED

The accelerated methods ("declining balance" and "sum-of-the-years-digits") clearly must be retained to recognize the greater loss of value in the early years of use. No knowledgeable person contends these allowances should be reduced.

TAX TREATMENT OF POLLUTION CONTROL FACILITIES AND EQUIPMENT PURCHASED TO COMPLY WITH THE OCCUPATIONAL SAFETY AND HEALTH ACT

The NMTBA shares the national concern with the abatement of pollution, and has made every effort to comply with pollution control standards. To facilitate such compliance, we urge that Congress provide more realistic tax treatment of pollution control equipment. Such equipment is expensive and requires both substantial initial investment and continued maintenance, yet does not contribute to productivity or increase earnings. Others have proposed that the taxpayer be given the option of a one year write-off of such pollution control facilities. We believe this proposal is based on considerations of fairness and equity, and fully support this position.

We also urge this Committee to give serious consideration to a proposal advanced by Congressman Steiger, which is now under consideration by the Committee on Ways and Means Task Force on Capital Formation, to provide for a similar one year write-off for equipment purchased to comply with the Occupational Safety and Health Act. The NMTBA is deeply concerned with the safety of both workers in the machine tool industry, and workers who will operate the machine tool equipment we distribute, and has consistently been supportive of OSHA.

However, it must be recognized that equipment purchased to comply with OSHA constitutes a major investment for a small business, yet adds nothing to its productivity while substantially increasing its costs. It is time for more

[18] As Secretary Simon indicated on July 8, the inadequacy of tax allowances for capital costs is not so much the fault of the Treasury or the Congress as it is the fault of the accounting profession. Leading accountants have not been able to agree on what constitutes "a reasonable allowance for wear and tear including obsolescence" either for tax purposes or financial reporting purposes. As Secretary Simon pointed out to the House Ways & Means Committee on July 8, 1975, the understatement of depreciation by accountants for financial purposes has also caused a serious erosion of the profits so urgently needed for capital investment. The Secretary quite justifiably condemned the "public relations bookkeeping" that has been sanctioned by accountants and has so adversely affected tax allowances and investment. The controversy and confusion over depreciation among accountants has added to the controversy and confusion in Congress and in the business community as to the depreciation methods to be used to properly reflect income.

realistic tax treatment of such equipment, and we believe that the proposal of Congressman Steiger is a just solution to this problem, and will greatly facilitate compliance by small businesses with the standards of OSHA.

THE DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) PROVISIONS (SECTIONS 991–997) SHOULD BE RETAINED WITHOUT CHANGE IN THE INTERNAL REVENUE CODE

The continuance of DISC is tremendously important to the relatively small companies in the machine tool industry. Many of these companies because of capital shortages cannot make the investment in plant facilities abroad or finance other operations there to supply their foreign markets. They have relied on cash flow provided by the DISC to increase domestic investment and jobs here in the U.S. so as to compete more effectively in foreign markets. The result has been a substantial increase in machine tool exports since the adoption of the DISC.

Export shipments of machine tools increased from $267.7 million in 1971 (the year the DISC was enacted) to $567.6 in 1975. This increase in exports accounts for over 8500 additional jobs in our industry today.

A recent survey of 111 machine tool companies disclosed that 41 companies are currently using the DISC and more are planning to use it. These 41 companies exported 14.8% of their total 1974 sales compared to 6.4% for the remaining 70 companies in the survey.

The DISC was enacted in 1971 when there was a deficit in the U.S. balance of payments. Following its enactment, in 1971–1975, the United States achieved a substantial balance of trade despite the tremendous increase in oil payments to the OPEC countries. It is not possible to determine just how much of that improvement was attributable to the DISC, but the Treasury has reported that the DISC accounted for some of the increase. This finds confirmation in the statements of many machine tool companies that the DISC has been a most important factor in the increase in their exports.

I would like to give my own company's experience as an example. In 1971, the year DISC was instituted, exports amounted to $2,462,000. Under DISC, export sales grew to $7,450,843 in 1975. DISC not only made it possible to triple export sales, but also allowed us to keep employment steady from 1971–1975.

At a time when employment is down and investment capital in short supply, our balance of trade would be seriously undermined by the repeal of the DISC. It would have the effect of greatly reducing the export business of hundreds of companies, many of them small companies in the machine tool industry, and thus reducing U.S. jobs and the U.S. balance of trade. They would have to abdicate much of their business to foreign plants.

The DISC in its present form has had the effect of minimizing the export of jobs abroad in a period of high unemployment, and also minimizing the export of capital at a time of great shortages in capital for investment in productive facilities in the United States.

The modification of the DISC provisions in H.R. 10612 would also have a serious adverse effect on the export business of many small companies. H.R. 10612 would permit DISC deferral for only half the profits derived from current export sales that exceed 75 percent of the average sales in a 3-year "base period" (1972–1974 will be the base period for taxable years through 1981). This proposal would greatly reduce the amount of deferred profit available for reinvestment in domestic export assets at a time when much greater reinvestment is needed to meet the increasing competition from foreign countries. Proponents of this proposal are closing their eyes to the fact that a short-term revenue gain will in the long run seriously undermine the health of our export trade, and domestic employment as well.

The arbitrary choice of a "base period" is particularly unfair to those companies which expended time, money and effort to increase foreign export sales during that period. This provision penalizes those who have worked hardest to build up their export business, thereby helping to bolster the sagging domestic economy and maintain employment during the recession period. It provides a substantial competitive advantage to both new entrants, and companies with lagging export sales during the "base period". Although the enactment of a five

year "grace period" between changes in base period slightly mitigates the tremendous burden placed on small companies trying to expand their export trade, the overall effect of his "incremental" approach to DISC will be to seriously hamper the ability of small businesses to compete in international trade at a time when domestic orders are still very lean.

Furthermore, we do not believe that the DISC should be a legislative vehicle for introducing moral and social reforms such as limiting foreign arms sales. That should really be the concern of legislation dealing with those separate and unrelated problems. Congress has far more direct and effective means of achieving such ends, as evidenced by recent legislation dealing specifically with the problem of foreign military sales. The Internal Revenue Code will lose its effectiveness if it is used to achieve social or defense-related purposes instead of carrying out an even-handed application and collection of taxes.

TAXATION OF FOREIGN SOURCE INCOME SHOULD NOT BE INCREASED

We would like to commend the House for its steadfast refusal to cripple the foreign export trade of small machine tool companies like my own company, Hill-Acme and others, by the adoption of proposals which would drastically increase taxation of foreign operations. These include annual taxation of the income of controlled foreign corporations, and repeal or drastic limitation of the foreign tax credit.

Such changes would seriously undermine the ability of U.S. corporations to do business abroad. In recent years many small machine tool companies have expanded their manufacturing and sales facilities at home and abroad at the urging of the Government in order to increase foreign sales. To abruptly withdraw promised tax benefits before such corporations have become firmly established abroad, and in their place substitute tax penalties far more severe than any other nation imposes on any of our foreign competitors would not only be unfair to them, but highly prejudicial to U.S. foreign trade. U.S. industry must have a reliable and stable tax base for its foreign operations because of the many unusual risks involved if it is to meet the strenous competition in world markets and maintain the favorable balance of trade the U.S. has been struggling so hard to achieve.

It has been the experience of controlled foreign corporations just getting under way or expanding during the past few years that they need to retain all or nearly all of their earnings for working capital and investment in the difficult economic and competitive climate overseas. Imposing a tax on earnings that cannot be remitted to the United States would be an intolerable and unfair burden and penalty.

Furthermore, such a proposal is contrary to long-established international tax policy. In no case do the laws of any foreign country where the subsidiary's parent corporation is a national impose taxes on those same earnings until they are distributed as dividends, unless it can be established that the earnings have been improperly diverted from the parent company. Imposition of such a tax by the United States would not only be misunderstood and resented by foreign governments (and also by a foreign corporation's minority shareholders and employees), but it might well be considered by some governments as an incursion on their soverignty and invite retaliation. Certainly it would not improve international relations or international trade.

The repeal of the foreign tax credit would result in a combined U.S. and foreign tax rate of about 75 percent in most nations, reducing by more than one-half the present earnings derived by U.S. companies from abroad.

It is clear that U.S. machine tool companies operating under such a massive tax burden could not hope to compete effectively, particularly with European and Japanese companies whose Governments not only provide them with substantial tax benefits, but may also directly subsidize their foreign operations.

The loss of international markets to our foreign competitors would have a drastic effect on our national economy and defense capability. U.S. Government and other surveys have shown that there is clearly a net benefit from foreign

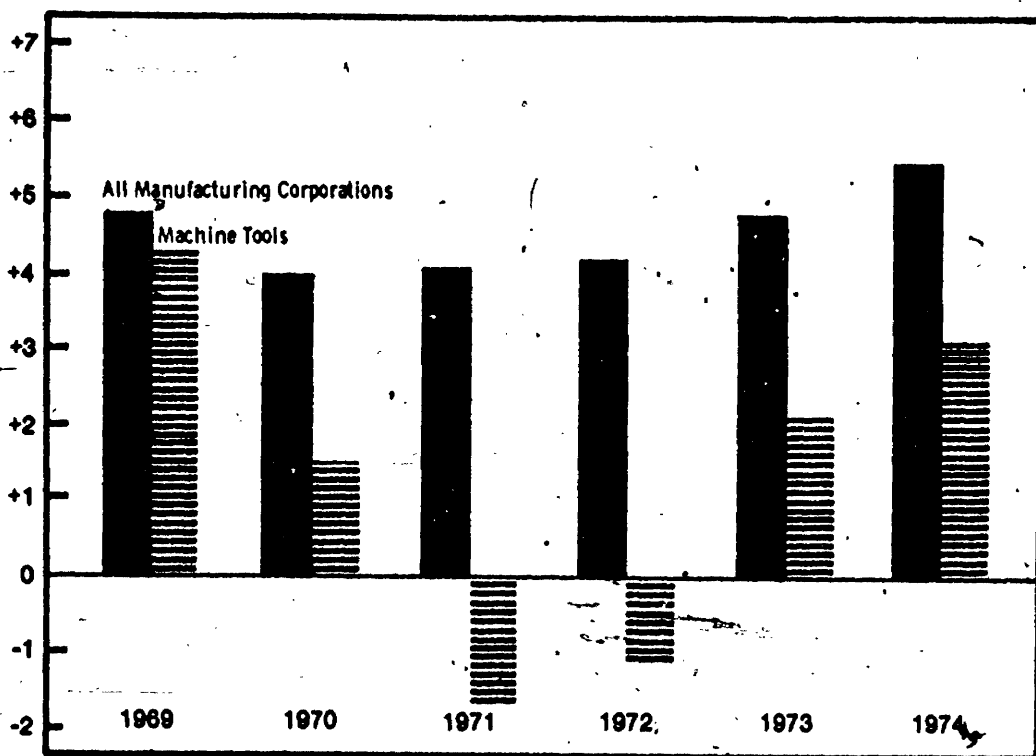
operations, and that they have contributed tremendously to the increase in industrial plants and jobs in the United States. The 1972 Department of Commerce study of multinational corporations estimates that more than 600,000 jobs would be lost if there were no U.S. foreign direct investment. The study concluded that 250,000 employees, principally production workers, would be out of work; that another 250,000 jobs would be eliminated in the home offices of U.S. multinational companies; and that an additional 100,000 jobs for supporting workers would also be lost.

SUMMARY

Increased capital investment is essential to the economic well-being of the United States. We must not let short-term revenue considerations, important though they are, blind us to the serious long-range consequences of insufficient capital formation to the health of U.S. industrial at home and abroad. Failure of our tax laws to provide adequate investment incentives will result in continuing inflationary pressures, higher unemployment, and a steady decline in productivity to threaten our economic health and posture as a leader in world trade. If we are to reverse this trend, we must intensify our efforts to expand and modernize U.S. industrial capacity. Only in this way can we achieve increased productivity, sales, profits and employment, which in turn will mean increased revenues to supply our future needs.

EXHIBIT A

NET PROFIT AFTER TAXES
All Manufacturing and Machine Tools, 1969-1974
(As A Percent of Total Sales)



Source: Federal Trade Commission
NMTBA

EXHIBIT B

AVERAGE NET INCOME OF ALL MANUFACTURING CORPORATIONS AND MACHINE TOOL COMPANIES SURVEYED, 1965 TO DATE

Year	Net income after taxes			
	As percent of sales		as percent of assets	
	All manufacturers [1]	Machine tool manufacturers [2]	All manufacturers [1]	Machine tool manufacturers [2]
1965	5.6	6.0	7.7	7.7
1966	5.6	6.5	7.7	8.8
1967	5.0	6.4	6.6	8.8
1968	5.1	5.6	6.6	7.3
1969	4.8	4.3	6.1	5.1
1970	4.0	1.5	4.9	1.9
1971	4.1	(1.7)	5.1	(1.7)
1972	4.3	(1.1)	5.5	(1.2)
1973	4.7	2.4	6.5	2.7
1974	5.5	3.2	7.6	4.1

[1] (a) Except newspapers.
[2] (b) Data based on the machine tool activities of these companies.

Note: Figures in parentheses represent negative figures.

Sources: National Machine Tool Builders' Association, Federal Trade Commission, "Quarterly Financial Report for Manufacturing Corporations" (quarterly).

AVERAGE NET INCOME OF MACHINE TOOL COMPANIES,[1] INCOME DATA IN PERCENT OF NET SALES, 1965 TO DATE

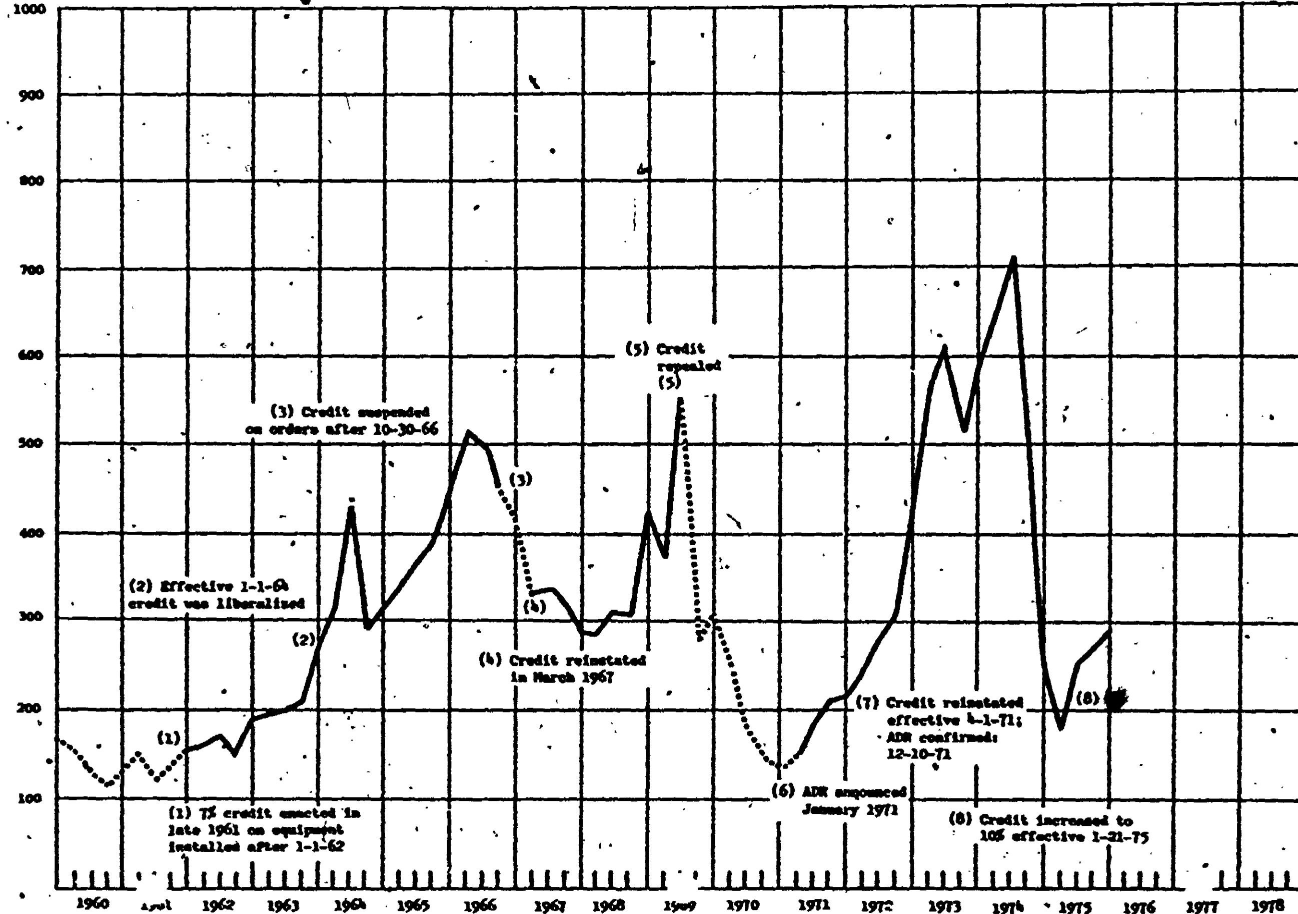
[Dollar amounts in millions]

Year	Total industry shipments	Sales of surveyed companies [1]	Net income			Surveyed companies [1] as percent of total
			As percent of sales		As percent of assets	
			Before taxes	After taxes	After taxes	
1965	$2,107	$1,139	11.2	6.0	7.7	54.0
1966	2,554	1,368	12.1	6.5	8.8	53.6
1967	2,841	1,425	12.1	6.4	8.8	50.2
1968	2,817	1,353	11.6	5.6	7.3	48.1
1969	2,835	1,251	8.9	4.3	5.1	44.1
1970	2,598	1,116	3.8	1.5	1.9	43.0
1971	2,019	739	(2.7)	(1.7)	(1.7)	36.6
1972	2,112	936	(1.3)	(1.1)	(1.2)	44.3
1973	(2)	1,270	4.3	2.4	2.7	(2)

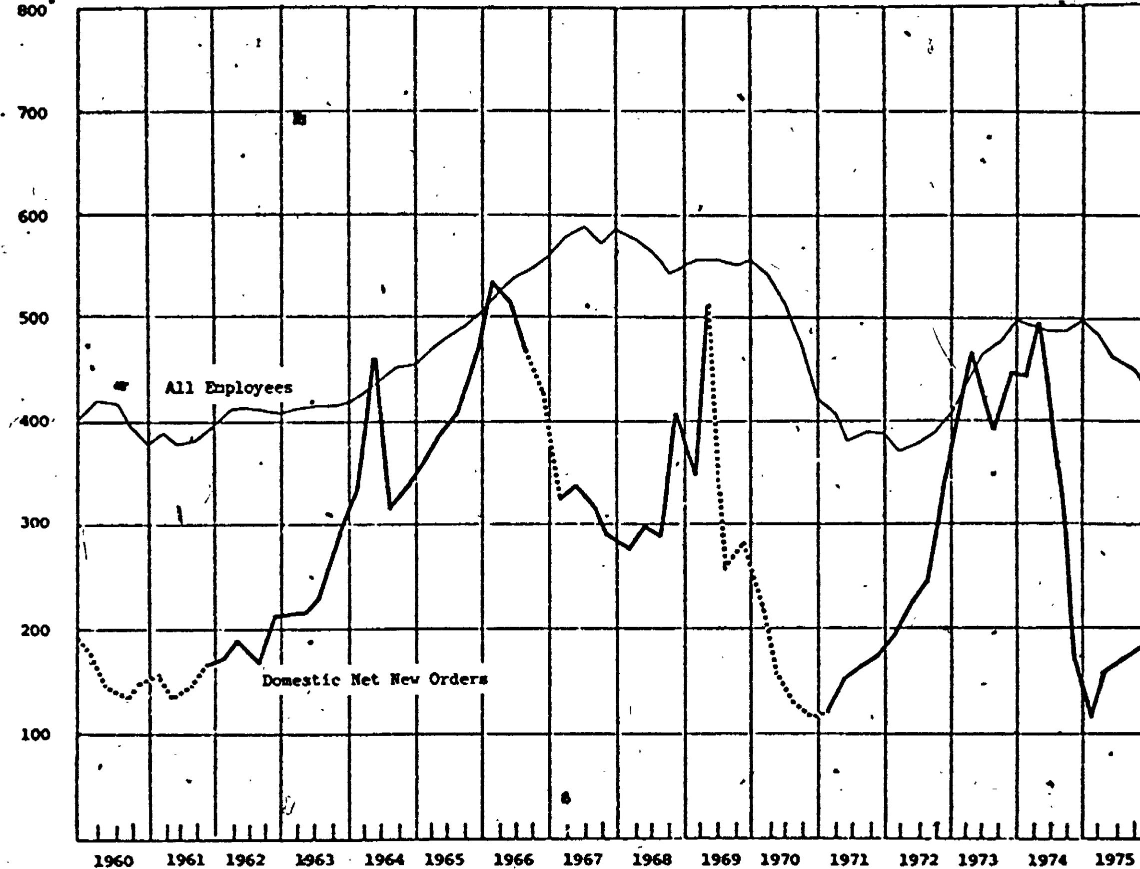
[1] Data based on the machine tool activities of these companies. [2] Not available.
Note: Figures in paretheses represent negative figures.

Sources: National Machine Tool Builders Association; U.S. Bureau of the Census, "Annual Survey of Manufacturers."

EXHIBIT C



MACHINE TOOL INDUSTRY
All Employees vs. Domestic Machine Tool Net New Orders in Constant Dollars (a)
Quarterly



(a) Current dollars deflated by the GNP implicit price deflator (annual average).

Source: National Machine Tool Builders' Assn.

—— Machine Tool All Employees
---- Machine Tool Domestic Net New Orders in Constant Dollars 1967=100. Solid line indicates investment credit in effect.

February, 1976

EXHIBIT D

EXHIBIT E

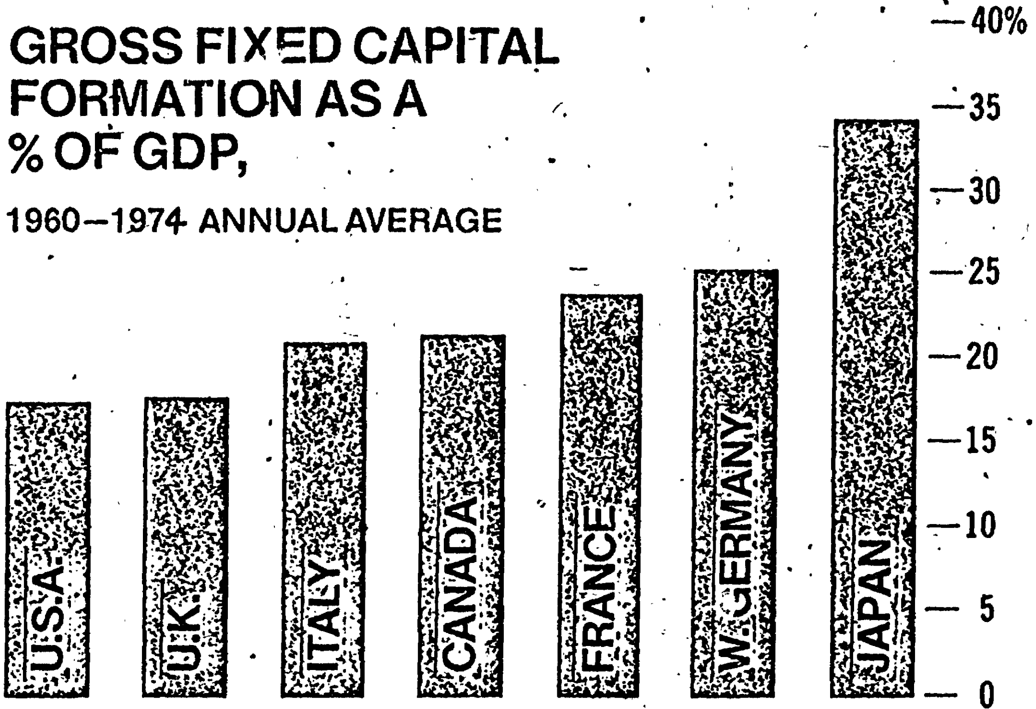
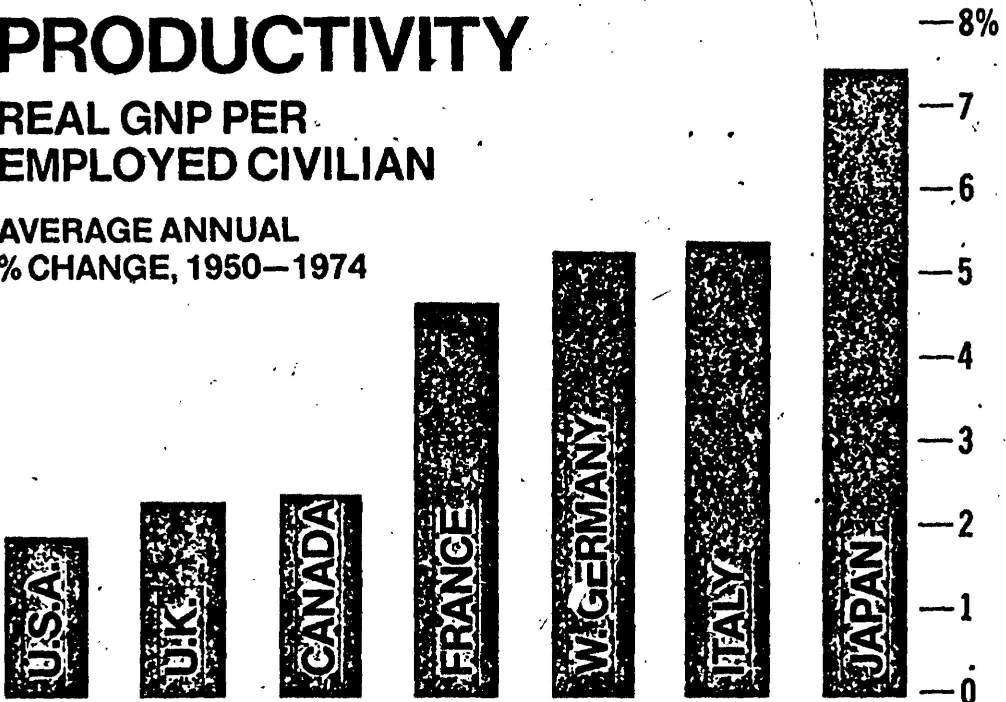


EXHIBIT F



Prepared by National Machine Tool Builders' Association

Exhibit G

COST RECOVERY ALLOWABLE FOR TAX PURPOSES ON MACHINERY AND EQUIPMENT

[Percent of original cost]

Country	1st year	3d year	7th year
United States 1970 (without investment credit or ADR)	7.7	33.9	66.1
United States current (10 percent investment credit and 20 percent ADR)	29.5	60.7	94.5
United States with (7 percent investment credit and 20 percent ADR)	23.5	54.7	88.5
United States with (7 percent investment credit only)	21.7	47.9	80.1
United Kingdom	100.0	100.0	100.0
Japan	37.1	63.9	88.1
France	31.3	67.5	94.9
Sweden	60.0	95.7	130.0
Italy	19.6	67.9	100.0
Belgium	20.0	48.8	89.0
Canada	50.0	100.0	100.0
Netherlands	14.0	58.0	108.0
West Germany	16.7	49.6	88.8

Note: These capital cost recovery allowances are based on statutory or other published provisons of law. As such they do not reflect informal or ad hoc arrangements that are frequently available in foreign countries—but not in the United States—to increase the rate of cost recovery actually allowed to industrial producers in those countries.

Source: Report of the President's task force on business taxation September 1970, pp. 28–29 updated by Price Waterhouse & Co.

EXHIBIT H

3. AGE OF MACHINE TOOLS IN 6 INDUSTRIAL NATIONS

	Percent under 10 yr old			Percent over 20 yr old		
	Cutting	Forming	Total	Cutting	Forming	Total
United States	34	31	33	28	29	28
Canada	40	35	38	24	29	25
Japan	63			23		
Italy	49	67	50	25	20	25
West Germany			63			7
United Kingdom	42	39	41	21	27	22
Soviet Union	54					

Source: United States, "American Machinist 11th Inventory," Canada, survey by "Canadian Machinery and Metalworking;" Japan, survey by Ministry of International Trade and Industry; Italy, estimate by Unione Construttori Italani Machine Utensile; West Germany, estimate by Verein Deutscher Maschinebau-Anstalten; United Kingdom, survey by "Metalworking Production"; Soviet Union, government survey cited by Stankii Instrument."

The 11th Inventory is based on data collected between February and July of this year and represents the status of equipment at about mid-1973.

The industries covered are those producing ordnance equipment, metal furniture, primary metals, fabricated metal products, all types of machinery, electrical and electronic equipment, automobiles, aerospace, ships, railroad equipment, instruments, and a variety of miscellaneous metal products. These industries, usually described as "the metalworking industries," have production processes that depend primarily on the use of machine tools. However, certain other types of equipment are required, and some of this is included in the sections on joining and other equipment. Throughout this discussion, the term "machine tools" refers to the metalcutting and metalforming machine sections of the Inventory.

The 11th Inventory is based on a computer model of the metalworking industries in 1973, construeted from information obtained from 12,408 plants that employ more than 3.3 million people. This sample, 31% of employment, is the largest ever obtained for an *American Machinist* Inventory. The 1968 Inventory, the previous record in this respect, was based on 10,078 plant reports that constituted a 29.5% sample on the basis of employment.

Details of the procedure will be found at the end of this summary report, and the structures of the universe and the sample are given in Table 14. Copies of the detailed computer printout of the 11th Inventory can also be obtained for research purposes.

TOTAL U.S. MACHINE PARK

What economists call the "park" of machine tools, that is, the total equipment available for use in the country, includes not only the equipment used by the metalworking industries but a substantial number of machines for other purposes. An estimate of this other equipment appears in Table 2a.

Other industries in Table 2a include railroad maintenance shops, automotive maintenance, air-transport maintenance, manufactured nonmetallic products, process industries, public utilities, and the mining, lumbering, and construction industries. Samplings of equipment in these industries made at various times in the past indicate that most of the equipment in these other industries is of the simpler, general-purpose types and usually has a higher average age level than does the equipment in the metalworking plants.

Government-owned arsenals and shipyards are, strictly speaking, metalworking industries. However, because they are not part of the census base on which the Inventory is constructed, they are included with the figures for "other industries." Exact data on the number of these machines is given in Table 2b. Machines shown in Active—contractor plants in Table 2b are included in the 11th Inventory.

Training machines in the estimate of total equipment include those belonging to colleges, vocational institutes, and public and private high schools. They do not include machines used for training in the metalworking industries, which are included with those industries. Some machines in the traning category are actually used for research instead of (or in addition to) training.

Storage and surplus machines include new and used machines in the hands of builders and distributors, and government-owned inactive machines. The latter are itemized in Table 2b.

Altogether, it is estimated that there are now 3,810,000 machine tools in the United States, of which 80% are in active use in metalworking plants and are covered by the 11th Inventory.

COMPARISON WITH OTHER COUNTRIES

The estimated total number of machines in the U.S. (3.8 million) compares with 4.4 million in the Soviet Union, 1.5 million in Japan, 1.3 million in West Germany, 856,000 in Great Britain, and 191,000 in Canada.

Comparisons of the percentage of machines under 10 years old and more than 20 years old for a number of these countries are provided in Table 3. All of these are based on recent studies; the only exception is for Japan, and here the data are based on a study conducted in 1967. Since 1967, the number of machine tools in Japan has more than doubled. This suggests that the percentage of machines under 10 years is much higher now than shown in the table.

The 10-year and 20-year counts are used to indicate the degree of modernization vs. obsolescence because they provide a uniform standard applicable to all types of equipment in all places. The 10-year measure was introduced by *American Machinist* in 1925. The 20-year measure was added in 1949.

Some machines over ten years old are still quite useful and some that are less than ten years old are already obsolete by current standards. However, the age measure is a uniform scale that can be applied consistently and repeatedly, and the 10-year mark has been used for the same reason in every country that has made such a study. Many also use the 20-year measure, and some have added a 5-year category.

In any case, individual judgment should be used in applying the age scale to individual machine types. That is, a higher average age is more acceptable for some types than for others.

Senator BYRD. Our next witness is Mr. Frederick G. Jaicks, chairman, American Iron and Steel Institute.

STATEMENT OF FREDERICK G. JAICKS, CHAIRMAN, AMERICAN IRON AND STEEL INSTITUTE, ACCOMPANIED BY DON STINNER, ASSISTANT CONTROLLER OF THE BETHLEHEM STEEL CO.

Mr. JAICKS. I am Fred Jaicks, chairman of Inland Steel Co. With me today is Mr. Don Stinner, assistant controller of the Bethlehem

Steel Co. Mr. Stinner is the chairman on our trade association's tax committee.

I am testifying today on behalf of the American Iron and Steel Institute, a trade association with 62 domestic member companies which account for approximately 95 percent of U.S. raw steel production.

You have copies of our formal testimony accompanied by our recently issued booklet, "Steel Industry Economics and Federal Income Tax Policy."[1] These spell out in considerable detail the tax policy recommendations of the steel industry.

Since the early 1950's the U.S. steel industry has undergone significant changes. It has lost its position as a steel producer for world markets. Its rate of return has dropped substantially and its financial position has been substantially weakened.

The primary causes of this deterioration in our industry are first and foremost the price controls that have been applied in one form or another to the steel industry, since the early 1960's. Second, the loss of markets to foreign producers who have been aided in various ways by their governments; and third, spiraling costs, particularly in the area of capital investment.

As we look to the future, the steel industry faces a substantial task in providing the steel products and employment opportunities required by our growing economy.

Conservative estimates show that by the early 1980's the domestic steel industry will require the addition of approximately 30 million tons of raw steel making capability to meet the demands of the country. Meeting this demand and upgrading productive capacity as well as meeting environmental requirements will require expenditures of approximately $5 billion annually over the next 6 to 9 years. This figure is almost three times the annual capital expenditures of the past 10 years.

In contrast to these expenditure requirements, the potential net cash flow available to the industry based on recent history is $2.8 billion annually. If these recent historical levels could be sustained and our debt-equity ratio maintained, this would generate an additional borrowing capacity of $500 million to $600 million a year. This means the industry faces a capital shortfall in the range of $1,700 million annually. If we are to bridge this gap, the steel industry must improve its profitability and the Federal Government must adopt tax policies which encourage capital formation.

Presently our tax laws are severely restricting our ability to generate the capital needed to keep your industry viable. We all know the steel industry is capital intensive and it takes a minimum of 2 or 3 years to bring steel facilities into operation with a slow payback in the early years of investment.

Additionally, our tax laws place the American steel industry at a disadvantage against foreign competitors, with respect to capital recovery. Many of our foreign competitors recover their capital through depreciation in 2 to 8 years rather than the average of 14.5 years for the domestic steel industry.

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[1] The booklet referred to was made a part of the official files of the committee.

Moreover, inflation compounds our difficulty with capital recovery. By the time capital is recovered, the purchasing power necessary to replace facilities has been lost through inflation. In order to help our industry generate the necessary cash flow to generate the new plant needed and the 80,000 to 90,000 jobs which we estimate are involved in the operation of these new facilities, we have made a number of specific recommendations which are included in our written submission for the record but which in the interest of time I will not enumerate in detail at this time.

Frequently, when recommendations are made to reduce the tax burdens on business investment, the rebuttal is made that a severe drain on the Government revenues will result. We find such assertions are misleading and without adequate consideration of the offsets produced by increased economic activity.

Accordingly, we made some studies in the steel industry of the impact of increasing the investment tax credit from 7 to 12 percent. In terms of present spending potential, these studies show that of the $3.3 billion we project will be available for spending each year, sufficient additional cash would be generated by the increased investment tax credit on that $3.3 billion, to construct a significant steel manufacturing facility. Over time, the profits generated by construction firms, plus the salaries and wages paid to construction workers directly associated with the installation of the facility, plus the salaries and wages paid to employers associated with the operation of the facility would generate approximately the the same amount of Federal income taxes lost through the increase in the credit.

This analysis does not include three major positive considerations that would result from the increased economic activity.

First, there is an obvious multiplier effect because of the profits and wages generated for suppliers and through construction of the facility. Moreover, there are significant multiplier effects for customers purchasing the steel products.

A second consideration is the elimination of the costs associated with support for the unemployed, which the Federal Government estimates at $3,600 annually.

Finally, both the economic activity directly associated with the construction and operation of the steel manufacturing facility, plus the multiplier effects noted above would greatly enhance the tax revenues of State and local governments.

Mr. Chairman, our system of enterprise in this country is in jeopardy. It is in jeopardy because many people do not understand that the productive machine in our country is fueled by the investment of private capital into the system. To maintain vigor in our system, we must support the system itself. We need tax laws in the United States that neither stifle nor discourage capital recovery, but rather stimulate the formation of the capital necessary to meet our Nation's goals. Adopting our proposals will go a long way toward helping the steel industry remain healthy and competitive, with full employment, and to expand our capacity to meet the Nation's growing demand for steel. They will also provide a proper balance between economic growth and desirable environmental goals.

Thank you very much for giving us the opportunity to express our views.

Senator BYRD. Senator Hansen.
Senator HANSEN. I have no questions.
Senator BYRD. Senator Ribicoff.
Senator RIBICOFF. I have no questions.
Senator BYRD. Thank you.
[The prepared statement of Mr. Jaicks follows:]

STATEMENT ON BEHALF OF THE AMERICAN IRON AND STEEL INSTITUTE BY FREDERICK G. JAICKS, CHAIRMAN, AMERICAN IRON AND STEEL INSTITUTE AND CHAIRMAN, INLAND STEEL CO.

Mr. Chairman and members of the Senate Finance Committee, we appreciate this opportunity to appear before you today. My name is Frederick G. Jaicks. I am Chairman and Chief Executive Officer of Inland Steel Company, but I am testifying today as Chairman of the American Iron and Steel Institute and on behalf of its sixty-two domestic member companies which account for approximately 95 percent of U.S. raw steel production.

The domestic iron and steel industry is a basic and major segment of the United States economy. It is a major employer—approximately 750,000 employees, including coal and iron ore mining, quarrying and related transportation employment and in 1974 it paid almost $10 billion in wages and salaries.

By the early 1980's, the industry estimates the U.S. economy will need 30 million tons of additional raw steel production capacity. When operational, this new capacity will require 85,000 to 90,000 full time employees for mining through steel finishing operations and it will also provide a substantial number of job opportunities for supplier and other types of ancillary industries. Because they are basic to most other major industries, steel products also support a substantial volume of employment for the entire country. Construction and installation of the facilities to produce this expansion of steelmaking capacity, as well as the additional facilities required to maintain present production capacity will produce substantial immediate employment requirements.

For the future, the steel industry faces a major task in providing the steel products and the employment opportunities required by our growing economy. If our economy is to continue to grow at a healthy rate, a viable steel industry is mandatory. Meeting the increased demand for 30 million tons of additional raw steel capacity, as well as replacing and maintaining present productive capacity, and meeting growing environmental requirements will require expenditures of approximately $5.0 billion per year, in 1975 dollars, over the next six to nine years. This figure is almost three times the average amount of capital expenditures made during the period 1965–1974, a period during which there was practically no net addition to raw steel capacity. In contrast to these expenditure requirements, the industry generated an average annual net cash flow of approximately $2.8 billion in 1973 and 1974, its highest volume years. Assuming this performance can be repeated consistently in the future and, also, that the industry maintains the higher debt to equity ratio of recent years, which would generate additional borrowing capacity of $500–$600 million annually, a capital shortfall in the approximate range of $1.7 billion *per year* is apparent. With respect to the ability of the industry to generate an average annual cash flow of $2.8 billion, we note that preliminary data for 1975 indicates that the industry was approximately 20% short of this goal last year.

The primary effort for reducing this projected shortfall must be directed toward continued improvement in the industry's profitability. That improvement began in 1973 and 1974 when, after several years of returns at or near the lowest levels of all industrial groups, the steel industry achieved a return on equity equal to the average of all manufacturing industries. Further improvement will require realistic government policies which avoid price controls and which help counteract noncompetitive practices of foreign steel producers supported by their home governments. The achievement of reasonable rates of return will maximize borrowing opportunities and, for the long-term, could permit the industry to obtain some part of its shortfall in funds from the equity market. These efforts at improving cash flow must be supported by Federal income tax policies that specificially encourage capital formation, particularly for those industries such as steel which require significant amounts of capital.

Frequently, where recommendations are made to reduce the tax burdens on business investments, the rebuttal is made that a severe drain on the govern-

ment revenues would result. We find that such assertions are misleading without adequate consideration of the offsets produced by increased economic activity. As an example therefore, we made some studies in the steel industry of the impact of increasing the investment tax credit from 7% to 12%. Those studies show that in terms of present spending potential, namely the $3.3 billion which we project would be available for spending each year, additional cash would be made available by the increased credit on that $3.3 billion to construct new steelmaking facilities. Overtime, the profits generated by construction firms plus the salaries and wages paid to construction workers directly associated with the installation of such facilities plus the salaries and wages paid to employers associated with the operation of the facility, would generate approximately the same amount of Federal income taxes lost through the increase in the credit.

This analysis does not include three major positive considerations which result from the increased economic activity. First, there is an obvious multiplier effect because of the profits and wages generated by suppliers both for the construction and operation of the resultant facility. Moreover, there are significant multiplier effects for customers who would purchase the steel products. A second consideration is the elimination of the costs of carrying the unemployed which the Federal government estimates at $3,600 per year per person. Finally, both the economic activity directly associated with the construction and operation of the steel manufacturing facility plus the multiplier effects noted above would greatly enhance the tax revenues of state and local governments.

These matters and others, including an economic history and details of a number of tax matters affecting the industry and recommendations for tax reform are set forth in the study, "Steel Industry Economics and Federal Income Tax Policy" which is appended hereto.

TAX RECOMMENDATIONS

The major revisions of the Federal income tax law that the industry recommends are as follows:

Capital recovery

The steel industry is greatly concerned about obtaining an effective capital recovery system, and is aware that certain past tax policies have been moving in that direction through the evolution of accelerated depreciation in the Revenue Code of 1954, investment credit and guideline depreciation in 1962, and ADR in 1971. It is in the steel industry's interest, and the nation's interest, to insure that this evolution continues through immediate legislation which would subsantially reduce the period of capital recovery for equipment within the framework of the ADR system, with a corresponding reduction in the lives of industrial buildings. A major long-term goal of Federal income tax policy should be the enactment of a simplified and flexible capital recovery system which would permit the cost of all productive industrial investment to be recovered over a period as short as five years, utilizing present depreciation methods and providing an election to the taxpayer as to the timing of the deduction. Industrial buildings should be included in this concept because in the steel industry they are highly specialized for the industrial activity they contain, and in fact are frequently integrated with the equipment they house. In addition, because of the extended construction periods of up to five years for some projects, the allowance of the deduction should be permitted as capital funds are expended rather than delayed until the project is placed in service, (a concept adopted in 1975 for investment tax credit).

Investment tax credit

The investment tax credit has now firmly established itself as a stimulating force in the economy. It is also recognized along with depreciation reform as a vital element in encouraging of capital formation. When first enacted, the nation was experiencing high unemployment, economic recession and idle plant capacity. The investment credit idea became a major element in President Kennedy's program to get things moving again—which it did. The investment credit directly and quickly provides the stimulant to replace old facilities, thereby providing jobs and improved productivity. From this activity flows many benefits, including the improvement of this nation's industrial competitiveness in a rapidly expanding worldwide market and the retention of jobs in the U.S. Since 1962, the

investment credit has been withdrawn and reinstated several times with the result that planning for capital investment by the steel industry, and industry generally, has been made more difficult. Stringent environmental standards requiring new equipment have substantially cut into other capital needs in the steel industry. Enactment of a permanent investment credit rate at 12% along with capital recovery improvements previously discussed herein would greatly aid this industry in meeting demands to clean up the environment, and at the same time, provide assistance in meeting capital spending objectives to sustain economic growth.

The economy is experiencing marked improvements over last year's recession but some areas are still in difficulty. A permanent 12% investment tax credit applicable when expenditures are made, and applicable without any corresponding reduction in the depreciable basis of the property should become a permanent part of the tax law. This would, in our view, help to further stimulate the national economy, for the long-term, as well as the short-term by increasing capital investment, encouraging productivity gains, stimulating new orders for materials, combating industrial obsolescence, thereby contributing to a rising national standard of living and reduced unemployment levels.

Pollution control facilities

The steel industry of this nation has already spent or committed close to three billion dollars for pollution control. Further, for each dollar of spending on pollution equipment there are added significant operating and maintenance costs. This is not the end of the problem because there are even greater costs ahead. Recently, the Arthur D. Little organization studied the steel industry and estimated that the environmental clean up bill for new and existing facilities by 1983 would cost an additional staggering 13.1 billion dollars, or 1.5 billion dollars per year. The $1.5 billion per year is comprised of 1.0 billion dollars for existing facilities and 500 million dollars for new facilities. The capital expenditures for pollution control facilities constitute about 30% of the industry's projected capital expenditure requirements over the next nine years.

It is apparent from these data that more realistic tax treatment of the costs of pollution control facilities is required in order to minimize the adverse effects on capital formation and the significant adverse impact on employment. Industry studies show that expenditures for pollution control facilities generate substantially less employment opportunities than equivalent amounts of expenditure for producion facilities.[1] Congress has previously recognized the validity of special treatment for pollution control facilities in the Tax Reform Act of 1969 when it provided for the amortization of the cost of these facilities over a sixty-month period, however this provision expired at the end of 1975. This treatment, for all practical purposes, proved to be ineffective for the steel industry. This results from the fact that the present value of depreciation plus the investment credit approximates the present value of a five-year amortization allowance. What Congress should now do is to enact legislation which would permit all expenditures for air and water pollution control facilities to be deductible as incurred, the reasoning being that these expenditures are not capital in nature because they do not, in a physical sense, prolong the life of the related asset or assets nor do they add to productive capacity; and, most significantly, they are generally not income-producing. Writing off such facilities as expenditures are made, would be consistent with their non-income producing character and consistent with the concept that the costs of non-productive facilities mandated for public purposes are appropriately shared with the general public through the Federal tax system. If this cannot be accomplished immediately, then an interim step should be taken to reduce the recovery period, while allowing accelerated methods of depreciation and the full application of the investment credit. Congress should also more precisely define "pollution control facility" so the incentives intended will not be denied, and the intent of Congress thwarted by unduly restrictive administrative interpretations such as those presently being enconutered by taxpayers attempting to gain Internal Revenue Service approval for industrial development bond financing.

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[1] An independent study performed by the consulting firm of Arthur D. Little, Inc. discloses that as many as 93,000 existing jobs are in jeopardy at marginal plants because of the potential shutdown of these facilities due to the impact of environmental requirements.

Encouragement of discovery and exploitation of raw materials

In order to provide an adequate supply of the raw materials (principally coal, limestone and iron ore) required to meet future demands for steel, sources of raw materials not presently in existence must be developed. Since these are wasting assets, those currently being consumed must be replaced with newly-developed sources, and additional new sources must be developed to supply increased demand in the future. Presently, the available supply of quality raw materials is inadequate to take care of high-level operations evén for existing capacity. It is imperative that new sources of these raw materials be developed.

In order to provide an adequate supply of the raw materials (principally facilities, this development should start immediately.

In addition to time, the development of these new sources will require large amounts of capital funds which will have to be obtained during a period when available funds are being actively sought by all types of industry.

Tax policies applying to these raw materials will be a major factor influencing the commitment of capital funds and, therefore, the development of new sources of raw materials which are essential to the maintaining of a strong steel industry and the furtherance of the strength and economic well-being of our nation.

We recommend that provisions of the tax law concerning these raw materials include:

Percentage depletion.—The percentage depletion allowance has proven effective in quantifying in economic terms the unique attributes of the extractive industires. It should be retained without geogrpahical restriction at least at the same levels existing prior to the Tax Reform Act of 1969.

Domestic iron ore.—Exploration expenditures should be currently deductible and not subject to recapture. Development expenditures should continue to be currently deductible. Exploration and development of these raw materials is similar to research and development to procure and develop new technology, and all such expenditures should be currently deductible and not subject to recapture.

The effectiveness of the percentage depletion allowance should not be impaired by the minimum tax. Corporations engaged in producing raw materials should never have been subjected to a dilution of the percentage depletion allowance by the imposition of the minimum tax in regard to this allowance.

Foreign iron ore.—Our nation is not and cannot be self-sufficient in raw materials. The steel industry is dependent upon foreign source iron core for much of its domestic steel production, particularly for coastal plants. Mining investments must be made in the country where the ore deposits exist in direct competition with investors from other developed countries seeking raw materials for their home steel industries. According to a recent study by the accounting firm of Cooper & Lybrand,[2] mining companies operating under the tax systems of other developed countries are in a better position to compete for mineral concessions than their United States counterparts because their tax systems permit a higher average return on equity investment than our tax laws do. Our tax laws should not be changed to widen this disparity but rather should be reformed in a manner that will enhance the competitive posture of our corporations in obtaining these needed sources of raw materials. We recommend that:

1. The foreign tax credit which prevents the double taxation of income earned abroad should be retained with the election of either the overall or the per country limitation. Furthermore, the restriction on the use of foreign tax credits arising from mining operations which is provided in Internal Revenue Code Section 901(e) represents an unrealistic segregation of income when applied to integrated steel operations, and should be eliminated.
2. In order to encourage investment in the much-needed iron ore deposits abroad, the investment tax credit should be made applicable to direct foreign investments in machinery and equipment, etc. by U.S. taxpayers.
3. Because of the uncertainties inherent in investments in foreign countries, particularly the developing countries in which significant iron ore reserves are likely to be found, capital recovery periods at least as short as

[2] Coopers & Lybrand, public accountants, special study dated Mar. 16, 1973, prepared at the request of the American Mining Congress and submitted as part of AMC's testimony on Mar. 20, 1973, before the House Committee on Ways and Means. The special study was subsequently updated to May 12, 1975.

those allowable for comparable domestic investment should be allowed to U.S. taxpayers operating abroad.

4. In order to encourage further exploration for minerals abroad, foreign exploration expenditures should be deductible as incurred.

5. Earnings of foreign corporations should not be subject to taxation in the United States until they are distributed to United States shareholders as dividends.

Coal.—The energy shortage has created a substantially increased demand for coal. The steel industry must now acquire this raw material in a market where others are competing to acquire it as an energy source. Reliance on coal as a major element in resolving our growing energy shortage, combined with an increased demand for coal as a raw material in the steel industry, dictates that new metallurgical and nonmetallurgical coal mines must be developed. To expedite the accomplishment of providing this vastly increased supply of coal, the depletion rate for coal should not be reduced.

MAXIMATION OF AMOUNT OF CASH FLOW RETAINED BY BUSINESS IN ORDER TO REINVEST IN PRODUCTIVE FACILITIES AND PROVIDE JOBS

In recent years the steel industry has greatly increased its debt. Present debt-to-equity ratios combined with the competition of large government debt financing make borrowing an extremely costly source of capital funds. Sale of equity securities at prices considered unrealistic when compared to underlying book values per share is not responsible management. The capital funds required to modernize and expand the steel industry must come to a large extent from the cash flow that the industry is able to retain and reinvest in productive facilities.

In order to obtain the capital funds needed to acquire the productive facilities and create productive jobs, steps should be taken to increase the amount of cash flow industry can retain and reinvest. Other industrialized natitons have already recognized this as a desirable goal and taken steps to provide incentives in their tax systems to attain this goal. Japan, Germany, Italy and France, all nations which compete with the domestic steel industry, have provisions in their tax laws to minimize or eliminate the onerous double taxation of dividends and enable a greater retention of cash flow in their corporations to enable the corporations to reinvest a greater portion of the cash flow in additional productive facilities to create more productive jobs. The steel industry recommends that changes in our tax laws be enacted to maximize the retention and reinvestment of cash flow in productive facilities and productive jobs. An effective means of fostering the retention and reinvestment of this cash flow would be to:

1. Reduce the corporation income tax rate and
2. Provide a deduction to the corporation for dividends paid or provide a lower income tax rate to corporations on the income distributed as dividends by the corporation.

THE MINIMUM TAX

Originally, the minimum tax was designed to prevent individuals subject to our highly progressive individual income tax rates from deliberately structuring the timing of deductions so as to lessen or eliminate tax liability. However, as enacted, the minimum tax applied to corporations. Since corporations are subject to a flat 48% tax rate, the problem to which the minimum tax was addressed does not arise in the case of corporations. The application of the minimum tax to corporations without the benefit of hearings, has subjected corporations to a tax burden that discourages capital formation at the very time when incentives are needed to encourage capital formation to construct facilities and create jobs. We urge the repeal of the minimum tax with respect to corporations. If corporations must be included, then in no event should they be denied a full deduction for regular income tax liability in the computation of minimum tax liability. Further, we recommend that excess regular income tax liability generated in a year should not only be permitted to be carried forward but should also be allowed as a carryback for all years covered by the minimum tax. Finally, percentage depletion arising from the operation of an extractive process, as opposed to passive investment, should be deleted from the computation of the minimum tax.

We hope the capital formation tax proposals the steel industry has submitted to this Committee today will be carefully studied. In the interest of a strong domestic steel industry, and a strong national economy in future years, we urge their adoption.

Senator BYRD. Our next witness is Norma Pace, senior vice president, American Paper Institute, accompanied by Neil Wissing, director of taxes, Weyerhaeuser Co.

You may proceed as you wish. Your statement will be printed in full in the record.

STATEMENT OF NORMA PACE, SENIOR VICE PRESIDENT, AMERICAN PAPER INSTITUTE, ACCOMPANIED BY NEIL WISSING, DIRECTOR OF TAXES, WEYERHAEUSER CO.

Ms. PACE. My name is Norma Pace and I am senior vice president of the American Paper Institute. With me is Neil Wissing, director of taxes, Weyerhaeuser Co., and chairman of the API Tax Committee.

We appreciate this opportunity to present to your chairman, Senator Long, and members of the Senate Committee on Finance our views on the need for appropriate tax legislation this year to help solve the capital formation problem, by promoting noninflationary economic growth.

I will outline the capital needs of the pulp, paper, and paperboard industry for the 1976–80 period, and Mr. Wissing will outline our tax policy recommendations designed to encourage the required capital investments.

I might add after adding this money into the investment stream our industry will operate at best at 96 percent of its capacity.

Mr. WISSING. Ms. Pace has highlighted our critical need to satisfy society's demand for tax reform.

Our written testimony details tax proposals which if enacted would significantly improve our industry's cash flow allowing us to achieve these objectives.

I will briefly cover a few of our proposals. In priority order, we would recommend a permanent investment tax credit at 12 percent available as expenditures are made with no tax liability limitation; a system of flexible capital cost allowances not tied to asset physical life; improvement in investment in pollution control equipment and, in addition, we strongly urge abandonment of the existing and proposed minimum tax rules as well as the complex LAL provisions of H.R. 10612.

We support the concept of a true minimum alternative tax to solve the problems of those who pay little or no taxes. Ms. Pace has created a clear picture of anticipated costs for environmental and other productive requirements and this, of course, is the key to our problem. If funds are not available for increased future capacity, the impact will be felt far beyond our industry alone.

While highly effective, the investment tax credit does not achieve its full potential simply because it is at risk every time Congress meets, particularly with respect to our industry where leadtime runs 3 to 5 years. So, a stable investment tax credit is critical.

Similarly the availability of the credit should not depend upon the taxpayers' liability as it now does under the 50 percent of tax limitation.

Our capital recovery cash flows are significantly lower than those of our foreign competitors. A pump which we would depreciate over 13 years would be written off much sooner by our foreign competitors.

The ADR system was a major step in the right direction but a flexible capital cost allowance would be considerably more appropriate.

The CHAIRMAN. I will have to ask you to suspend your testimony at this point to allow for questioning. I have read the summary.

Senator CURTIS. I want to commend both of the witnesses for their very clear and understandable statements.

Ms. Pace, we are delighted that you are here. We have been hearing the needs of business from the men all the time and now that you have appeared, we know it is true.

Mr. Wissing, I too have followed the summary, and this committee has a very good staff and individual members have a very good staff. Please do not feel that your full paper has not made a contribution. Before we commence our decisionmaking these papers will be summarized and studied.

I understand that the timber industry is affected by the provisions of the House bill governing the use of the accural method accounting by farming corporations. Would you explain how the timber industry is affected?

Mr. WISSING. It is affected in two ways. In response to your specific question, the farming provisions, there is an accounting rule in that section designed specifically for farm corporations which would require the capitalization of all expenses of maintenance of the farm. If it is applied to timber crops now defined under that bill as farming operations, this would preclude the deduction of all interim maintenance expenses for corporate tree growing during the period in which the crop is in its growth cycle.

In many cases, this would extend 20 to 60 years. It would simply destroy the economics of tree farming.

Senator CURTIS. Would you now comment on the LAL rules. Do you want to add anything with respect to that?

Mr. WISSING. In LAL specifically, that impacts as the bill is now written on the individual tree farmer and would cause him to defer his costs of maintaining the forest over the intervening period of crop growth. Since those people are in effect the suppliers for our industry, it would have a very deleterious effect upon their ability to invest in tree farming operations, and the small farmer could wind up being destroyed.

Senator CURTIS. Are some of the members of your Institute exporting their products and, if so, has DISC been beneficial to them?

Mr. WISSING. Quite a few of our members are exporters, and they do utilize the provisions of DISC.

We think it is highly favorable for every dollar of tax deferral that you receive from DISC, you are required to invest $2 in export assets. This results in substantial job increases in investments in the United States at relatively minimal cost to the Treasury.

Senator CURTIS. How about the asset depreciation range? Is that beneficial, too?

Mr. WISSING. Yes; it is highly beneficial. We believe as other speakers have expressed here today that the asset depreciation ranges are a proper method but they could be significantly improved if we would adopt a system somewhat more along the line of the Canadian system which allow flexible deductions for depreciation within broad classes of groups of lives.

Senator CURTIS. I think this committee is very sympathetic toward the capital and other needs of business. However, we are in a situation where we will not have the full or final decision. These matters will be contested and debated on the floor. Organized labor, the AFL-CIO, has recommended repeal of many provisions of the existing law such as DISC and that effort seems to be spearheaded from the distinguished Senator from Massachusetts, Mr. Kennedy, who recommended the repeal of a number of things including ADR and DISC.

So we will have to be prepared to defend these provisions on the Senate floor.

It is also entirely possible that the issue will arise before we act on a tax bill. It has been reported that, under the new budget resolution that will come before the Senate in just a little while, there will be an attempt made to increase the estimate of revenues by about $2 billion under the theory of revenue reform which, in effect, is to destroy some of the provisions we have here.

Now, that will not mean that the actual tax bill will be voted upon, but it will be a battle over the commitment of the Senate to do certain things.

Your testimony has been very helpful.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Ms. Pace, as I understand your testimony, the paper industry will need $30 billion in capital for the 5-year period 1976 through 1980. Of that total, about 20 percent is being required because of congressional legislation in the field of pollution abatement.

Ms. PACE. That is correct, Senator.

Senator BYRD. That is an expenditure over which your industry has little control. It is mandated by the government.

Ms. PACE. That is true, and let me clarify that further. The pollution abatement regulations apply to what we call the primary sector of our business. That is the paper and paperboard that is produced. If you look at those expenditures alone, these pollution abatement outlays represent one-third of them. The limitation of these regulations is on the primary sector, and that is our concern. I think most people don't realize the contribution of pollution abatement expenditures to this critical part of our capital investment. It is one third of that.

Senator BYRD. One-third of your total capital needs?

Ms. PACE. Of the capital needs at the primary end which is where the pollution abatement applies. When you make the envelopes or boxes the pollution abatement outlays are not that large, but it is at the primary end where you produce the paper and paperboard out of which you make these converted products that the limitation by those constraints applies.

One-third of the capital is tied up in that way.

Senator BYRD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. I have five questions I would like to submit to our distinguished witnesses and I ask unanimous consent that their responses may be included in the record as though given now.

The CHAIRMAN. Thank you very much. We will give your statement every thoughtful consideration we can.

[The questions and responses and the prepared statement of the American Paper Institute follows:]

Question 1. Why have you selected an operating rate of 96 percent of capacity as the basis for your projections of future capital requirements?

Answer. As a pratical matter the industry cannot operate at 100 percent of capacity. For the past 3 years API has been studying the operations of about 260 machines which account for 65 percent of the paper grades produced in the Nation and during that period downtime resulting from strikes, lack of raw material, machine breakdowns, etc. have averaged about 5 percent of total capacity. Although an individual machine may operate occasionally at more than 100 percent for the industry as a whole we cannot count on having the total measured capacity available for production. Actually a more realistic assumption would have been a 95 percent operating rate but we wish to keep our calculations on a conservative basis. It is interesting to note that the average operating rate in our industry during the 1964-74 period was 93.1 percent. If the industry were to operate at that level, it would have to add 2.5 million more tons to the capacity figures presented in this report; that is the capacity by the end of 1980 would have to be approximately 83 million tons rather than 80.4 million tons we estimated on the basis of an assumed 96 percent operating rate.

Question 2. Why has debt been the only source of financing for your industry during the past 10 years?

Answer. The paper industry has not been unique in its dependence upon debt markets during the past 15 years. The reason is that the equity market for many companies producing basic or commodity type goods have not been particularly promising sources of funds. Earnings potentials were not regarded favorably.

In addition the stock market has been impacted by the existing double taxation of dividend income. This double taxation imposes a particularly heavy tax burden on equity capital and has therefore contributed to the large increases in debt financing. During the past 15 years about 65 percent of our industry's expansion has been financed by retained earnings; the remaining 35 percent came from debt expansion. Sales of stock did in fact provide some cash in 4 out of the past 15 years but these sales were generally offset by stock repurchases later on, which reflected the generally low prices of paper stocks.

Question 3. What is the impact of changing environmental control requirements, particularly in an inflationary climate such as we have experienced?

Answer. Pollution abatement outlays which in the paper industry account for about one-third of its total capital outlays for pulp, paper and paperboard production have these effects:

1. They limit the amount of each flow available for investment in modernization and expansion.
2. They add to the cost of investing and of producing paper.
3. They cause significant delays in the investment decision.
4. They can result in an imbalance between demand and supply that could add to the inflationary pressures in the nation.

In a study of the economic impacts on the paper industry of pollution control costs, URS estimates the costs of meeting 1977 and 1983 standards at $7.5 billion in constant dollars and $12.5 billion in current dollars. (This assumes a 10% rise in equipment costs.) For the period 1976 and 1977, pollution abatement outlays will actually match the total amount anticipated as needed for the investment in *new* capacity in the paper industry. Thus the pressure on cash flow from these expenditures is large and the possibility that the industry will not be able to expand in line with demand is a real concern. Since the Treasury has effectively blocked the availability of industrial revenue bond financing for pollution control for the last two years, the pressure on our capital resources has become even more intense. Using the 1969-73 experience in the paper industry, the URS study shows that capital spending decisions in 1970-72 were adversely affected by both the rising level of pollution abatement expenditures during that period and price controls that limited profitability in the industry. This failure to invest

limited supply in 1973–1974 and created an extra-inflationary pressure. The result was a double upward pressure on prices: (1) manufacturers tried to recover the costs of building and operating pollution abatement facilities, and (2) capacity was insufficient to meet the growth in demand leading to a classic case of demand/pull inflation.

Question 4. Why can't the pulp and paper industry totally convert its products domestically and then ship them into foreign markets?

Answer. Some of the consumer products produced by our industry are converted domestically and flow into offshore markets. However, major products such as shipping containers and folding cartons must be converted on site because they are specifically designed for local customers and the transportation costs of shipping the converted products are prohibitive. The important point here is that the primary conversion with its large capital investment in primary facilities, and its attendant large work force is located in the U.S. Only the relatively inexpensive secondary converting plants are located at the foreign site, and these captive plants insure an outlet for the primary production. Without them, the primary domestic industry would not be able to meet foreign competition and we would soon be totally out of the foreign market.

Question 5. I understand industry generally has experienced difficulty in depreciating power facilities. Is the pulp and paper industry having trouble in this area?

Answer. In 1974, Treasury altered its approach to the asset depreciation range system, and pulled all electrical and steam generation and distribution facilities out of the industry classifications, setting them up in a separate classification. In the case of the pulp and paper industry, this increased the basic depreciable life on these facilities from 16 years to 28 years. Our industry generates up to about 65% of its power requirements internally and utilizes boiler facilities which are not equivalent to similar facilities used by a utility. The thrust of the industry is to become energy self-sufficient, while at the same time significantly reducing or eliminating emissions which might have a negative impact on the environment. This trend obviously should be encouraged rather than discouraged by tax policy. Over the last 18 months, the pulp and paper industry has been unable to budge the Treasury from its position on this matter, even though the Treasury's approach clearly runs directly contrary to stated national goals in the fields of energy conservation and pollution control.

TESTIMONY OF THE AMERICAN PAPER INSTITUTE, BY NORMA PACE, SENIOR VICE PRESIDENT

(The American Paper Institute is the national trade association of the pulp, paper and paperboard industry. The 200 member firms of the Institute produce more than 90% of all the pulp, paper and paperboard manufactured domestically. Net sales of the paper and allied products industry were $32 billion in 1975. The industry employs more than 700,000 people in approximately 6,000 facilities; last year its outlay in wages, salaries and benefits amounted to over $9 billion. The industry paid approximately $2 billion in Federal, state and local taxes last year. The paper industry ranks with the ten largest industries in the United States, and operates in virtually every state in the Union.)

My name is Norma Pace and I am a Senior Vice President of the American Paper Institute. With me is Neil Wissing, Director of Taxes, Weyerhaeuser Company, and Chairman of the API Tax Committee.

We appreciate this opportunity to present to your Chairman, Senator Long, and members of the Senate Committee on Finance our views on the need for appropriate tax legislation this year to help solve the capital formation problem by promoting non-inflationary economic growth.

I will outline the capital needs of the pulp, paper and paperboard industry for the 1976–1980 period, and Mr. Wissing will outline our tax policy recommendations designed to encourage the required capital investments.

THE CAPITAL NEEDS OF THE PULP, PAPER AND PAPERBOARD INDUSTRY (1976–1980)

The American Paper Institute estimates that the paper industry will have to finance $30.7 billion for both plant and equipment and working capital in 1976–

1980. Retained cash flow can provide about 60% of these requirements; it will have to seek outside financing for about 40% of its needs in the next five years. Because of the industry's relatively high debt/equity ratio this gap, amounting to $12 billion for the five year period, presents significant hurdles in the investment process. Three alternatives are possible:

1. Expansion needs of the industry will not be met resulting in an estimated job loss of 245,000 by 1980 for the industry, its suppliers and its customers. The tax loss resulting from this failure to invest and generate income is estimated at least at $1.3 billion in current dollars. These exclude the impact of a potential outlay of several billions for OASHA and energy conservation requirements.

2. The necessary funds may be obtained from borrowing and/or from the issuance of more stock. Both of these are normal and justifiable routes for funding plant expansion projects. But at any given time borrowers may be unwilling to lend to the industry or investors may feel reluctant to risk the financing through the purchase of stock. Prudent managers may also decide that the current conditions of their financial statements do not warrant such actions and many in the paper industry feel that way at present. During the past ten years the industry has not relied on stock issues; debt expansion financed 36% of its needs. The resulting increase in the debt/equity ratios have been large enough to deter further borrowing.

3. Alternatively prices and margins could be increased to provide more internal sources of funds for expansion. Such recourse, however, will dampen the growth rate of both the industry and the economy, subject individuals to a new round of double digit inflation and invite another experiment with price controls which will prove as harmful to the nation's growth as its predecessors. For example, if the industry were to supply half of the needed cash from internally generated funds, paper prices would rise an additional 22% over the general inflation rate in the five year period. Thus if the inflation rate for the nation as a whole were 6% a year, paper prices would have to advance 10% a year to provide the needed 70% of the funds from retained profits.

Whatever the recourse, the mere existence of this large gap poses problems for the industry and slows down investment decisions. This is hardly conducive to attaining the desirable goal of a return to full employment with relatively stable prices. This Committee can speed up the timetable for returning to a healthy, inflation-resistant economy by recommending appropriate tax policies to encourage investments.

Demand forecasts

The production of paper and paperboard has advanced sharply since the spring of 1975. In February, the operating rate exceeded 91%. Since 95% represents the practical maximum operating rate for the industry, February's performance shows that many companies were operating at their maximum. According to the latest capacity survey of the American Paper Institute, the industry plans to increase capacity 3.5% this year so that there will be no shortage of paper or paperboard. Still these statistics indicate that the industry must invest in new capacity if it is to meet the growth needs of the nation with relatively stable operations and prices. But the industry needs some help. The rising costs of capital facilities coupled with the heavy demands on cash flow resulting from EPA regulations suggest that the industry will not meet its capacity requirements.

Capacity requirements

The demand for paper and paperboard has grown at close to a 4% annual rate in the post World War II period. Some slowdown in growth for both the U.S. economy and the paper industry is expected by many analysts. On the assumption that the economy grows 5% a year (a growth that would suggest unemployment rates in excess of 5% a year through 1980), paper and paperboard demand can be expected to reach 75.7 million tons in 1980. This compares with an estimated demand of 62 million tons in 1976. If the industry were to operate at 96% of capacity during the five year period, capacity by the end of 1980 would have to be 80.4 million tons. With capacity estimated at 68.8 million tons at the end of 1975, the industry should add 11.6 million tons to capacity in the next five years. Actually the industry operated at an average rate of 93% during 1964–1974. If the industry were to return to that level of operations it would have to add 2.5 million more tons to capacity.

Capital requirements

The pulp and paper industry estimates it will have to spend about $27 billion on plant and equipment in the 1976–1980 period to provide the capacity needed to meet anticipated demands. The average annual outlay of $5.3 billion compares with the peak outlays of $2.9 billion made in 1975. In addition to the annual outlay of $5.9 billion for plant and equipment about $800 million a year will be needed for working capital. The requirements can be broken down as follows:

Total capital requirements

	Billions
For pollution abatement	$5.9
For primary facilities	11.2
For converting facilities	6.7
For timberlands	2.9
Total for plant and equipment	26.7
For working capital	4.0
Total requirements	30.7

Figures above exclude amounts needed to meet OASHA and energy requirements which could add billions more to these requirements.

The industry invests to produce primary products such as pulp, paper and paperboard which it sells or processes into converted products such as boxes, envelopes, towelling, writing paper, etc. The capital requirements for primary product capacity of $11.2 billion consists of $6.3 billion for new capacity and $4.8 billion for replacement and modernization of existing capacity.

The pollution abatement expenditures of $5.9 billion for the five year period compares with a total of $3 billion spent by the industry during the past *10* years. These costs are mandated b ythe EPA to meet ever-changing water and air quality standards. Since these regulations apply primarily to the primary sector of the industry; that is, to the production of pulu, paper and paperboard and not to the finishing or converting operations, pollution abatement outlays in our industry in the five years ahead will practically equal the amount the industry will have to spend for new capacity.

Capital recovery allowances will fall short of needed outlays by far. In the five years ahead, heavy investments must be made to tune up and maintain the large tonnages that were added to the industry's capacity in the 1965–1969 period. These facilities are now in rapid stages of wear-out and this aging of facilities preempts an increasing proportion of the industry's cash flow. Furthermore, obsolescence of facilities is accelerating.

Funds available

We estimate that existing depreciation allowances can fund about 30% of the total capital requirements; the remaining 70% or about $21 billion will have to be supplied by retained earnings and external sources such as the stock or bond markets. While this financing is theoretically possible, its sheer size slows down the investment decision. The resource to debt is limited by the fact that the paper industry already has a high debt burden; total long-term debt is equivalent to 49% of equity for the industry as a whole and is about 33% of total capital. The 49% average includes some companies where debt is as much as 66% of equity. The more aggressive investing companies are clearly up to and beyond their prudent debt limits. The equity market does occasionally provide opportunities but these are of relatively short duration and limited to those companies with sustained records of earnings performance. The overall financing is so large that it inhibits an orderly and sustained capital investment program, the kind that is needed to provide more job opportunities and greater job satisfaction.

Our best forecast is that retained earnings will provide about 36% of the $21 billion needed after depreciation allowances. The remaining 64% will have to come from the securities and credit markets.

Specific forecasts often invite criticism. To avoid these, API has based calculations on the impact of failure to invest on three assumptions as follows: that the industry obtain 40% of its financing requirements after depreciation,

which would be the situation if the industry relied upon retained earnings alone and maintained a constant debt/equity ratio. API has also calculated effects on capacity and job creation if 65% and 75% were financed.

A summary of the impacts follows:

Assumption	Needed capacity tonnage lost (millions)	Direct and indurect jobs lost	Direct and indirect tax revenue lost (millions)
40 percent financing	9.2	245,000	$1,330
65 percent financing	4.6	123,000	700
75 percent linancing	3.2	86,000	500

The schedule above shows that if the industry can provide only 40% of its cash requirements after allowance for depreciation, it will not build 9.2 million tons of capacity by 1980, resulting in a loss of 245,000 potential jobs and over $1.3 billion of tax revenue. This scenario is possible if the industry were to earn 6% after taxes on sales in the five year period and not change it debt/equity position. The other scenarios would require the industry to increase profit performance (mostly through price increases) and debt/equity financing. These figures exclude the impact of potential expenditures for OASHA and energy conserving equipment. These could increase the job impact.

Pulp, paper and paperboard—Averages 1964–74

	Percent
Growth rate in production	[1] 3.8
Average operating rate	93.1
Maximum operating rate (in 1973)	96.2
Profits as percent of sales	4.8
Debt as percent of total new capital	36.5
Growth rate in investment	[1] 10.3
Productivity—Index 1967–70	[1] 3.9
Prices	[1] 5.1

[1] Per year.

ESTIMATED DEMAND AND CAPACITY REQUIREMENTS

[Millions of tons]

Year	Production	Capacity, end of year
1975	52.7	68.8
Forecasts:		
1976	62.0	70.2
1977	67.3	71.4
1978	70.0	74.4
1979	72.9	77.4
1980	75.7	80.4

CAPITAL REQUIREMENTS TO MEET ANTICIPATED DEMAND [1]

[In billions of dollars]

Year	Primary facilities [2]	Converting facilities	Pollution abatement	Timber lands	Sum
1975	981	857	644	435	2,917
Forecasts:					
1976	1,194	900	506	478	3,078
1977	1,300	1,000	750	526	3,576
1978	2,615	1,369	1,200	578	5,762
1979	2,871	1,622	1,700	636	6,829
1980	3,194	1,816	1,700	1,700	7,410

[1] Assumes a capital inflation rate of 10 percent a year.

[2] Assumes 25 percent of additional capacity will come from improvements on existing machines and 75 percent will require new machines. The cost per ton of a new facility will be 3 to 4 times larger than an improvement.

Note: These figures are not forecasts of industry spending. They are API estimates of the cost of building the facilities needed to meet growing demand.

Cash flow 1976–80

Production	347.9 million tons.
Average Price[1]	$725 a ton.
Industry Sales	$253.7 billion.
After-Tax Profits[2]	$5.2 billion.
Retained Profits[3]	$7.6 billion.

[1] Assumes 6 percent a year inflation rate.
[2] Based on 6 percent after-tax return. The average in 1964–74 was 4.8 percent.
[3] Based on experience in average pay-out for the industry and for other commodity-type industries. Assumes 50 percent pay-out.

TAX POLICY RECOMMENDATIONS TO ENCOURAGE INVESTMENT

Investment tax credit

We strongly urge that the basic investment tax credit be increased from 10% to 12% and that this increase be permanent. Our industry, and indeed all industry, needs an appropriate, permanent investment tax credit to stabilize the capital investment position. The investment tax credit, which was instituted in 1962, has been subject to highly variable treatment; it has been enacted, suspended, reinstated, repealed, reenacted and increased on a temporary basis. Since our industry must plan and execute its large capital expenditures over lead times of three to five years, elimination of the volatility in the credit would significantly improve its effectiveness. The tax credit offsets some of the steep escalation in capital costs in our industry and provides a source of cash flow to finance not only job producing facilities but also non-productive pollution control expenditures.

Elimination of tax liability limitation

We urge permanent elimination of the tax liability limitation on availability of the investment tax credit in any one taxable year. Removing this limitation would have a positive impact on new investment, particularly in periods of economic downturn.

Extend investment tax credit to industrial buildings

We urge extension of the investment tax credit to industrial buildings which house or are used in connection with manufacturing facilities. All manufacturing plants require structures and related utility systems, whose economic and obsolescence aspects are more similar to industrial machinery and equipment than to residential buildings. Moreover, the extension of the credit to buildings would ease the tax audit burden of attempting to distinguish between buildings and machinery and equipment.

Qualified progress expenditures

Capital costs in the paper industry have doubled over the past five years. Allowing the investment tax credit to apply when construction is started provides cash for the industry at the crucial time when the industry is burdened with heavy cash outlays. This is a significant improvement over previous law which deferred application of the credit until an asset was "placed in service." However, present law limits the effectiveness of this new concept by requiring the application on a graduated basis extending over a five year period. We recommend repeal or reduction of the five year phase-in rule.

Depreciation

We urge that Congress enact a system of flexible, optional cost recovery deductions independent of any rigid allowances based on useful life. Current depreciation allowances in our industry, and industry generally, are inadequate to provide for replacement of existing assets.

Much of our machinery and equipment is becoming obsolete because of rapid changes in the papermaking process and new environmental protection requirements. The impact of rapid inflation, coupled with the need for modernization and replacement of outmoded facilities and accelerating demands for capital dollars to protect the environment, highlights the need for significant improvement in our existing capital recovery system.

Both the Canadian system, under which a taxpayer can take up to a two year write-off period for machinery and equipment, and the United Kingdom system which allows a 100% write-off for machinery in the first year, are examples of

capital cost recovery systems which recognize current requirements. Both of these systems permit almost complete flexibility in the timing of depreciation deductions by taxpayers.

We recommend, at the very least, adoption of a capital recovery allowance system along the lines outlined in H.R. 7543. This would permit machinery and equipment and pollution control facilities to be written off over a five year period and buildings over a ten year period, with taxpayers permitted to elect deductions of 0% to the maximum allowed for any year as costs are incurred. Unused deductions would be carried forward indefinitely.

Implementation of this or a similar concept would greatly assist in the generation of internal funds for capital investment.

DEPRECIABLE LIFE OF INDUSTRIAL STEAM AND ELECTRIC GENERATION AND DISTRIBUTION SYSTEMS

In the face of increasing capital requirement for productive facilities, environmental controls, and sharply rising costs of energy-saving investments, the Treasury Department has administratively reduced depreciation deductions for steam and electric generation and distribution systems by a substantial amount. This, of course, worsens the problem of providing sufficient investment capital.

This decision flies in the face of clear cut national policy to encourage investment in power facilities which are energy efficient and environmentally acceptable. In the pulp and paper industry in-house power generation and distribution facilities are an integral part of the manufacturing process and also key elements in pollution abatement. As a consequence, they have no life separate from the manufacturing complexes of which they are a part. The assumption seems to have been made that these facilities should be equated with commercial power complexes, but the process orientation of these assets as well as their differential utilization in the paper industry clearly distinguishes these assets from utility usage.

This Treasury decision clearly ignores the high incidence of obsolescence inherent in facilities being constructed today. Improvements in technology to meet power requirements and pollution abatement standards often render facilities obsolete by the time they are fully constructed. We raise this item here simply because we have labored for 18 months trying to correct this situation and key investment decisions are being delayed pending resolution of this issue.

Corporate tax rate reduction

We support the President's proposal to reduce the corporate income tax rate from 48% to 46%. We agree with Secretary Simon's explanation before your Committee in which he pointed out that until Congress can effect integration of the corporate and personal income taxes, "this modest relief of the extra burden of tax should cause beneficial increases in the rate of capital formation." Mr. Simon clearly and appropriately recognizes the need for measures to increase the profitability of business activity as the key to increasing investment in more efficient plant and equipment.

Corporate surtax exemption and rates

We support a permanent $50,000 surtax exemption and continuation beyond 1977 of the normal tax rate of 20% on the first $25,000 of taxable income and 22% on the next $25,000.

These tax reductions, which are scheduled to expire in June, should be extended. We suggest Committee consideration of a possible increase in the surtax exemption to $100,000 in order to adequately reflect the inflationary impact over the past twenty-five years, or since the $25,000 surtax exemption was enacted.

Integration of corporate and individual taxes

We strongly support the concept of eliminating double taxation of dividend income. This double taxation places serious obstacles in the way of necessary expansion of capital formation. It imposes a particularly heavy tax burden on corporate profits and equity capital and has contributed to the large increases in debt financing.

Many proposals for eliminating or reducing the double taxation of corporate profits have been advanced, with varying direct impact upon the corporation and shareholders. We urge careful study by your Committee of all of these proposals, in order to arrive at the most effective method or combination of methods to improve capital formation and increase the efficiency of capital use.

Capital gains

In the Revenue Act of 1969 capital gains tax rates were increased for both individuals and corporations by over 20%, and the minimum tax on tax preferences including capital gains was adopted. These two actions by Congress in effect increased the maximum corporate capital gains rate from 25% to 30.75% and the individual rate to 36.5%, resulting in a negative influence on the availability of individual savings and corporate investment.

These actions should be reversed. We urge that the corporate capital gains rate be reduced to 25% and that capital gains be deleted as a tax preference item subject to the minimum tax.

Industrial pollution controls

We have repeatedly pointed up the need for financial assistance in funding our huge investments in non-productive pollution control facilities.

Mrs. Pace has outlined the tremendous capital needs of our industry over the next five years, including our mandated spending for non-productive environmental control. As indicated in a recent study prepared for the American Paper Institute, environmental control outlays through 1984 will amount to 30–40% of total capital spending in the primary sector to meet growing pulp, paper and paperboard needs.

These massive pollution abatement expenditures have a significant impact on our industry's ability to generate sufficient margin on sales and return on investment to enable us to provide both the required level of environmental control expenditures and funds for required capacity increases. Without some assistance in the financing of these huge outlays, the industry will fail to meet demand. Among other consequences, a shortage of supply could result in distortions in demand and more inflation in the paper market.

Specifically our recommendations are as follows:

1. We recommend a doubling of the investment tax credit on all qualified pollution control facilities.

2. We recommend eliminating the requirement that the five year amortization provision and the investment credit are mutually exclusive. The five year writeoff provision was appropriately enacted to allow for rapid recovery of capital costs invested in environmental protection facilities. It seems highly inconsistent to take away the normal and justified investment credit incentive merely because costs can be recovered over a shorter period than normally allowed.

3. The five year amortization provision should be eliminated from the list of tax preference items. Inclusion of this amortization as a minimum tax item effectively reduces the impact of this capital recovery provision.

4. We urge an appropriate legislative definition of pollution control facilities, in order to qualify pollution control facilities for either tax-exempt financing or the proposals noted above. We have addressed this problem at the regulatory level and have been attempting to clarify this definition for some time. However, it has become clear that a legislative solution is needed.

We would be most pleased to work with your Committee in helping to arrive at an appropriate legislative definition.

Taxation of foreign source income

Deferral of income of controlled foreign subsidiaries

We strongly support the concept of deferral. Any limitation of deferral of taxes on foreign source income would result in less funds being made available for capital investment in overseas markets to sustain or strengthen the competitive position of foreign operations, which in many cases serve as markets for U.S. produced goods.

Two years ago we prepared and submitted a study to the staff of the Joint Committee on Internal Revenue Taxation in response to a request for information concerning the possible impact of forced repatriation on our industry. We pointed out that new or planned facilities must initially be supported by a very high or even accelerating flow of funds for capital investment, and a relatively heavy flow of funds is required for replacement purposes in order to maintain competitiveness in these foreign markets.

Our presentation included the results of a survey among a sample group of member companies. Of particular significance was the fact that the repatriation proposal we were evaluating would have resulted in a significant proportion of the total increase in tax liability accruing to foreign governments rather than to the U.S. Treasury.

Foreign tax credit

We oppose limitations on use of the foreign tax credit.

By permitting foreign taxes paid to be credited against U.S. income taxes on foreign source income, the foreign tax credit prevents double taxation of such income.

The possibility of abuse is limited by existing specific provisions of the Internal Revenue Code. Any reduction in the foreign tax credit would result in U.S. companies paying a higher tax on income earned abroad than their foreign competitors. In effect, this would put American companies at a decided competitive disadvantage.

DISC

We strongly support continuation of DISC provisions which permit deferral of tax on one-half of export income from U.S. made products. We oppose the provisions in H.R. 10612 which would restrict the application of DISC, benefits of which can be considered a partial offset to export incentives provided by foreign governments.

Many of our member companies have formed and are operating under the DISC provisions. The DISC incentive, although not large, will continue to help us meet increasing competition in foreign markets. Further, at a short term cost of a 12½% tax deferral on export profits, the Treasury insures a reinvestment by these exporters of 25% of total export profits in domestic export assets.

We also strongly object to the unwarranted additional requirement that forest products must meet a 50% domestic manufacture criterion in order to qualify for DISC treatment. This clearly discriminates against our industry.

Minimum tax and proposed limitation on artificial losses (LAL)

We strongly oppose the minimum tax and limitation on artificial losses (LAL) provisions in H.R. 10612.

We want to reaffirm our objection to imposing minimum tax provisions on corporations. In effect, application of the minimum tax to corporations constitutes a penalty tax primarily on those corporations that have capital gains. Our specific comments, however, will be directed to the proposed changes affecting individuals and partnerships.

Our basic objection rests on the fact that both existing and proposed provisions constitute an additional tax burden. This contrasts with the initial rationale for the minimum tax at the time of its enactment in 1969, which presumed that this provision would in fact impose a tax on all those who previously would have escaped taxation completely.

The proposed amendments in H.R. 10612 very clearly result in an additional tax burden, regardless of the ordinary tax liability. These provisions should be dropped.

The LAL concept, as proposed in H.R. 10612, is an attempt to eliminate so-called "tax shelters." Under this proposal certain deductions would be allowed only against income from the related investments.

This provision would most certainly reduce total capital investment. As Chairman Long said recently, Congress must be careful "not to put people out of work." Investments in shelters often are "high-risk seed money" to start projects which create jobs. Further, implementation of the provisions as outlined in H.R. 10612 would disallow otherwise allowable deductions.

This proposal, in combination with proposed changes in the minimum tax, would have a serious negative impact on total capital formation.

We support, instead, a true minimum tax on economic income such as outlined by Representative James Jones during House consideration of H.R. 10612. As Chairman Long indicated in a discussion of such a concept, this would represent an alternative tax to be imposed if it were higher than an individual's regular tax.

Energy conservation

The American Paper Institute has pledged its cooperation in the effort to free the nation from its excessive dependence on foreign sources of energy supply and to reduce the disruptive influence of high energy costs on this country's economy.

American businesses, especially capital intensive industries such as ours, are seriously handicapped by cost constraints in efforts to reach voluntary energy conservation objectives.

Under these circumstances we urge careful consideration of the following recommendations designed to enable our industry to make an even greater contribution to the nation's energy conservation goals:

1. We support an increased investment tax credit, above the level now under consideration by your Committee, to provide incentives for capital investment in fuel conserving equipment, including facilities which will increase utilization of solid wastes as a source of energy.

2. As we are recommending for environmental facilities, we urge allowance of both the investment tax credit and five year amortization to apply to all energy conserving equipment.

3. And, of course, we want to emphasize the need for a positive solution to the problem we outlined in our discussion of industry power systems.

This concludes our presentation. We would be pleased to answer any questions Committee members may have.

The CHAIRMAN. Our next witness is Mr. Robert W. Schoeffler, president, American Machine Tool Distributors' Association, accompanied by James C. Kelley, executive vice president.

STATEMENT OF ROBERT W. SCHOEFFLER, PRESIDENT, AMERICAN MACHINE TOOL DISTRIBUTORS' ASSOCIATION, ACCOMPANIED BY JAMES C. KELLEY, EXECUTIVE VICE PRESIDENT

Mr. SCHOEFFLER. I'm president of the American Machine Tool Distributors' Association, a national trade association with 257 distributor members and 115 machine tool and accessory builders who are marketing associate members.

To conserve the time of the committee, I am presenting a brief summary of our full statement which has been distributed to the committee members. I would like to ask that this full statement documenting and explaining our position be included in the record of the hearings.

Senator BYRD. It is so ordered.

Mr. SCHOEFFLER. Machine tool distributors are small businesses ranging from $1 million to $25 million in sales per year. I'm also president of Marshall & Huschart Machinery Co., a machine tool distributor covering a five-State area out of Chicago, Ill. With me today is Mr. James C. Kelley, executive vice president of our association.

We appreciate this opportunity to make recommendations for revisions in our tax structure which, as so many witnesses have pointed out, unduly encourages personal consumption and Government spending and discourages personal savings and capital formation.

This country has become the greatest Nation in the world in less than 200 years for only two reasons: First, a four-letter word that is not a dirty word—work. And, second—profit. We have worked with our hands and our money to make a profit. I personally do not believe that the words "work" and "profit" are dirty.

We feel that the tax laws, as they are presently written, are biased against investment in productive facilities. As the Secretary of the Treasury, Mr. Simon, so clearly pointed out to this committee on March 17, it is the tax law bias against investment in new machinery and equipment that keeps U.S. industry from competing more effectively in world markets. The United States simply cannot afford to have the smallest capital recovery tax allowances of any leading industrial nation in the world.

Our anti-profit and anti-work tax policies have resulted in the lowest rate of capital investment of any leading industrial nation in the world.

Our machine tool industry, while it is small in comparison to the giant corporations in the United States, is so essential that economists and Government use it as a barometer as to the health of our industrial economy. Other industrial nations have used this industry as a yard stick to encourage purchase of new equipment to reduce industrial obsolescence and low productivity.

The United States relies more heavily than any other industrial nation on the income tax for a source of revenue. This puts a penalty on efficient low-cost production that increases profits and, therefore, the burden of tax. More reliance must be placed on consumption taxes, such as the value added tax, that taxes costs instead of income. Double taxation of corporate earnings, which erodes profits required for reinvestment, must also be eliminated so that people with money can reinvest to make more money—and create more employment.

The tax issue with regard to capital investment is simple. It is just a matter of the timing of writeoffs. What is a reasonable period for the write-off of capital costs? Speaking for machine tool distributors—which really is why I'm here—the period of write-offs cannot be set in concrete. With the technological advances that we have made in the last 15 years, some machine tools are not the latest design when they are being installed in the customer's plant.

In the simplest terms, boiled down, the entire controversy over depreciation has involved only a question of timing and it has been largely a wasteful exercise in futility. We will not encourage the investment needed to meet our national needs by labeling the shorter write-off periods of the asset depreciation range system and the accelerated depreciation methods as "loopholes," "windfalls" or "subsidies." We must educate the people of the United States that our capitalistic system of investment for profit is what made us what we are today.

Investment depends entirely on making a risk reasonable. You cannot expect investors to buy equipment on which they cannot be reasonably sure that they will make a profit on their investment after taxes. If too long a period for writeoffs is required by the Government, then the investment will not be made. If the tax credit is provided to make up the inadequacy of the tax writeoff period and the impact of inflation, the investment may or may not be made depending on, of course, the amount of the credit. This does not involve any question of "loopholes" or "windfalls"; it is simply a matter of recovering capital costs against the income they produce over a period that will justify the investment. Other industrial countries have recognized this and encourage their industry to modernize. For example, Canada now permits statutory writeoff in 2 years.

We machine tool distributors sell and service the majority of the machine tools installed in the United States. We know from talking to our customers that the principal reason given to us over and over again for not purchasing equipment is the inadequate cost recovery allowances in the tax structure which discourage new machine purchases; 85 percent of the machine tools purchased in the United States should be purchased by what we consider small business to keep them com-

petitive with both the large companies in the United States as well as their foreign competitors. It is not uncommon for a small business to be required to make an investment in a single machine that costs from $100,000 to $300,000—which may be the equivalent of the company's entire net worth.

We, therefore, make the following recommendations:

First, the special investment problems of small business must be recognized in tax revision to encourage modernization and replacement of production facilities. More specifically, the corporate surtax exemption should be increased to $100,000 and made a permanent part of the tax law; the additional first-year depreciation provided in section 179 should be continued, with an increase in the $10,000 ceiling to $100,000; and the earnings accumulation ceiling in section 531 should be increased to $300,000.

Second, the capital recovery problems of all business should be recognized and dealt with. More specifically, the investment tax credit should be continued and made a permanent part of the capital recovery tax structure with an increase in the rate to 15 percent; the asset depreciation range system should be continued and liberalized to 40 percent; and the accelerated depreciation methods provided in section 167(b) should be continued.

One final word; we feel that the increased investments, that our recommendations will generate will increase productivity, sales, profits, and employment. This will inevitably increase tax revenues from both corporations and individuals. These long-term increases will far exceed any short-term losses that may occur.

Senator BYRD. Thank you, sir.

Senator Curtis?

Senator CURTIS. I want to thank you for your statement. I have studied it in some detail as you were going along. I think you have made a distinct contribution to the tasks that we have here, and they will contribute a great deal to our efforts.

I believe that, facing all the problems we have with deficit financing, we should at this time concentrate our tax efforts on those things that will meet the needs of our economy and spur enterprise into job-producing activities. I am convinced one of the many things that must be taken into account is the need for greater capital formation. Many of the things you have recommended here bear directly on that and we appreciate having you before the committee.

Senator BYRD. Thank you, Mr. Schoeffler.

[The prepared statement of the American Machine Tool Distributors' Association follows:]

STATEMENT OF AMERICAN MACHINE TOOL DISTRIBUTORS' ASSOCIATION

SUMMARY

My name is Robert W. Schoeffler. I am President of the American Machine Tool Distributors' Association (AMTDA), a national trade association with 257 distributor members and 115 machine tool builders with membership as marketing associates. Machine tool distributors are small businesses with sales beginning in the $1 million range and running as high as $25 million for a very few distributors.

I am also President of Marshall & Huschart Machine Company, a machine tool distributor in Chicago, Ill.

Mr. James C. Kelley, Executive Vice President of AMTDA, is with me today.

To conserve the time of the Committee, I am presenting a brief summary of our full statement which has been distributed to the Committee members. I request that this full statement documenting and explaining our position be included in the record of the hearings.

The tax structure unduly encourages consumption and spending and discourages investment in industrial facilities required to increase productivity.

As compared with other industrial nations, the United States now has the lowest rate of productivity increase, the lowest rate of capital investment in relation to GNP, and the highest level of industrial obsolescence.

Those who minimize the need for investment and claim "the United States has plenty of industrial capacity" ignore the fact that much of it (more than any other industrial nation) is obsolete high-cost, non-competitive capacity.

Shortage of capital and lack of investment threatens the economic health of the United States and its ability to compete effectively in world markets.

The economic health of key industries like the machine tool industry is also theratened. All U.S. industry and its defense and commercial business is dependent on the machine tool industry for increased production and increased productivity.

Economists recognize the machine tool industry as a barometer of the health of all industry. Statistics show that the health of this industry and those dependent upon it is not good. New orders for machine tools reached their lowest level in many years in 1975.

After several years of being second to West Germany, the U.S. has only recently resumed leadership in the production of machine tools. However, West Germany remains a very close second, with Russia and Japan rapidly gaining ground.

For the first time in history, the United States is being threatened as the leading nation in the consumption of machine tools. The threat comes from the Soviet Union with a consumption figure of $2.284 billion as compared with the U.S. figure of $2.285 billion.

All these statistics showing the deteriorating position of U.S. industry have serious implications in terms of our competitive trade position and our relative defense capability.

No one would claim that our tax structure is the cause of all these problems but when we compare our tax structure with those of other industrial nations, it is clear that it is a principal cause.

The United States relies more heavily on the income tax than other industrial nations.

They rely more on consumption taxes such as the value-added tax (VAT). The VAT puts a premium on low-cost, efficiency production by taxing costs. The income tax puts a penalty on low-cost, efficient production by taxing the income instead of the costs.

The United States has lower tax allowances for depreciation and related capital costs than any other industrial nation. These other nations have adopted capital recovery tax allowances that will insure adequate capital investment. The United States has not.

The U.S. Government, industry and the accountants continue to be bogged down in wholly unnecessary, even ridiculous, controversies over abstruse accounting concepts involving nothing more than the timing of the writeoff of capital costs.

The time has come to end this controversy and adopt a simple cost recovery system such as a streamlined and simplified ADR system (with a 40% instead of a 20% variable in the guideline life), or a standardized single-rate capital recovery system such as that proposed by Congressman Waggonner and others in H.R. 8226. This would be similar to the Canadian and other foreign systems.

The accelerated methods should continue to be available to recognize the loss of value and obsolescence in the initial period of use.

The investment credit should be made a permanent part of the tax structure to recognize the inadequacy of Section 167 depreciation allowances to take fully into account the impact of obsolescence and inflation on the cost of replacement. Events have proved that a 7% credit or even a 10% credit will not provide the stimulus for the tremendous capital formulation and investment that is required. For this reason, and to make U.S. allowances comparable to those of other nations, the investment credit should be increased to 15%. The right to the credit

should vest in the year the commitment to investment is made. The utilization of the credit can be deferred until the year of payment or installation.

To assist small business in solving its critical problems of raising capital for investment, the following tax revisions should also be made:

(*a*) The ceiling of $10,000 in Section 179 should be increased to $100,000. The present minimal additional allowance of $2,000 (20% of $10,000) simply is not meaningful.

(*b*) The earnings accumulation ceiling in Section 531 should be increased to $300,000. The penalty tax on the accumulation of earnings is a serious barrier to capital investment and modernization for the small company.

(*c*) The surtax exemption should be increased to $100,000, and made a permanent part of the tax law. The 20% tax rate on the initial $25,000 of taxable income should also be permanently incorporated into our tax law.

STATEMENT

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We appreciate this opportunity to make recommendations for revisions in our tax structure which, as so many witnesses have pointed out, unduly encourages personal consumption and government spending and discourages personal saving and capital formation.

THE TAX LAW BIAS AGAINST INVESTMENT IN PRODUCTIVE FACILITIES

As Secretary of the Treasury William Simon so clearly pointed out to this Committee on March 17, 1976, it is this tax law bias that has had such an adverse effect on investment in technologically advanced machinery so urgently needed to enable U.S. industry to compete effectively in world markets.

With the highest labor rates in the world, and the most urgent need for capital investment to reduce industrial obsolescence, and increase productivity and jobs, the United States simply cannot afford to have the smallest capital recovery tax allowances of any of the leading industrial nations.[1]

Our anti-investment, anti-business tax policy has resulted in a lower rate of capital investment in the United States in relation to GNP than in any other leading industrial nation.

A recent study[2] comparing fixed investment with productivity growth rates for the major industrial countries has dramatized the shockingly poor relative performance of the U.S. economy during the past fifteen years. Of the twelve industrial countries covered, the U.S. ranked last in average annual percent growth in real gross domestic product (GDP) per civilian employee, and last in output per man-hour in manufacturing.[3]

Although the United States greatly improved its balance of payments during this period, this improved performance is largely attributable to such external factors as the sharply rising rate of hourly compensation in Japan and Europe, and the devaluation of the dollar since 1971 relative to the Japanese yen and most European currencies. We cannot rely on such factors in the future to maintain our competitive position in world markets. Only a concentrated effort to

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[1] Statistical comparisons of cost allowances published by the Treasury Department indicate that U.S. allowances are the equivalent of or slightly larger than the allowances in W[illegible]t Germ[illegible]ny and Japan. However, these statistics are based on statutory provisions, [illegible] in th[illegible]

modernize and expand our industrial facilities will enable us to become sufficiently productive to remain economically and politically a world leader. As Secretary Simon pointed out to the Joint Economic Committee on November 21, 1975, this in turn will depend on removing the present bias in our tax laws against capital formation.

Increased Productivity Depends on Machine Tools

Although we are understandably concerned with the adverse effect the tax structure has had on the health of the machine tool industry in recent years, you may be certain that our overriding concern is the adverse effect it has had on the entire economy in the loss of investment, productivity and jobs. In view of the fact, however, that this small but essential industry has come to be regarded by economists and the Government as a barometer of the health of all U.S. industry, its economic health, or lack of it, is not without significance, and is in fact an important measure of the health of the entire economy. All industrial nations today use this industry yardstick and recognize that technologically advanced machine tools must be relied on, and their production encouraged and increased, to bring solutions to the problems of high industrial obsolescence and low productivity.

THE UNITED STATES MUST MAINTAIN ITS POSITION AS WORLD LEADER IN MACHINE TOOL PRODUCTION AND CONSUMPTION

After several years of being second to West Germany, the U.S. has only recently resumed leadership in the production of machine tools.[4] However, West Germany remains a very close second, and Russia and Japan are rapidly gaining ground.

Perhaps even more significant in terms of industrial growth and defense potential is the fact that the Soviet Union may soon displace the United States as the leading nation in the consumption of machine tools. Consumption figures show $2.284 billion of machine tools for the Soviet Union and $2.285 billion for the United States, with the Soviet Union closing the gap.[5]

There is a general recognition in industry and in the Defense Department that thihs is most prejudicial to our national interest, and that, despite our continuing leadership in machine tool engineering and design, it has serious implications in terms of our defense capabilities and our competitive position in world trade.

ECONOMIC ILLITERACY IS A CRITICAL PROBLEM

The machine tool industry is genuinely alarmed at the prospect of a diminishing U.S. capability to compete effectively with other nations in world markets. The economic illiteracy and the ignorance among U.S. voters as to the tremendous need for capital and the role of profits in providing jobs is frightening. It is this illiteracy and apathy as reflected among other things in an inadequate and inequitable tax structure that has been a principal cause of the continuing shortages of capital and capital investment, the high ratio of corporate debt to equity, the tremendous shortfalls of capital predicted for the future, and the loss of millions of jobs that are absolutely dependent upon increased business investment.[6]

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[4] 1975 machine tool production figures, provided by the American Machinist: United States, $2,480,000,000; West Germany, $2,344,900,000; Soviet Union, $1,963,800,000; Japan, $1,089,000,000.

[5] Consumption figures provided by the American Machinist (Jan. 14, 1976).

[6] The public simply does not seem to realize that between $35,000 and $50,000 of capital investment is required just to provide one job in a capital intensive industry. Recently a machine tool executive gave the following simple illustraiton of the indispensable role of capital in providing jobs:

"Today a man can leave his home in New York City and arrive at his destination in San Francisco in 4½ hours. He can do this because he is able to utilize as much or more than $10,000,000,000 in capital created by American business and invested in all the facilities that produced the facilities he used in his travel: The taxicabs, the super highways, the extensive airport facilities, a 747 jumbojet, *et al.* One hundred fifty years ago it took that same man roughly 200 days to go from New York to San Francisco and involved probably $200.00 in capital for his Conestoga wagon, his horses and related equipment.

There is no job that can be done manually any faster today than it was done 200 years ago. It is not possible for a man to earn more than a dollar or two an hour for moving earth with a shovel, but if someone will provide the capital required to furnish him with a three-cubic-yard tractor, he can then earn $10 to $15 per hour. From this capital and this investment comes our productivity, our jobs and our higher standard of living.

Fortunately, there seems to be at long last some recognition by Government, management and labor [7] that the unacceptably high rates of inflation, unemployment, and industrial obsolescence, and the critically low rates of productivity and investment in productive facilities, stem in considerable part, at least, from public ignorance and the tax bias against investment in production facilities. There is also a growing recognition that these problems will not find solutions until Congress changes our tax structure to eliminate this bias. As Secretary Simon stated to the Joint Economic Committee on November 21, 1975:

> First and foremost, we must have a much greater understanding on the part of the public on the basic concept of capital. Capital is the cornerstone of increased productivity, of higher real wages, of greater job opportunities, of a stronger competitive position internationally, and of holding down the rate of inflation.
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> * * * * * * *
>
> If we do not have adequate capital investment, we will continue to experience higher unemployment and inflation than we want.

THE UNITED STATES RELIES TOO HEAVILY ON THE HIGH RATE INCOME TAX

The United States relies more heavily than any other industrial nation on the income tax which puts a penalty on the efficient, low-cost production that increases profits and also, of course, the burden of the tax. More reliance must be placed on consumption taxes such as the value-added tax (VAT) that taxes costs instead of income. Also, tax rates on income must be lowered if the United States is to be fully competitive with these other nations with tax structures encouraging low-cost production.[8] Double taxation of corporate earnings which erodes profits required for reinvestment must also be eliminated. More reasonable and equitable treatment must also be accorded capital gains to encourage investment and make the capital markets available to business.

THE TAX ISSUE IS SIMPLE: IT IS ONLY THE TIMING OF THE WRITEOFF

Actually, the tax bias against capital investment has remained in the statute principally because of differences of opinion between Government, industry and accountants over what is a reasonable period for the writeoff of capital costs. Boiled down to its simplest terms, the entire controversy over depreciation has involved only a question of timing, and it has been largely a wasteful exercise in futility.

Almost without exception, each new Administration with its short-range intest in maximizing revenue; has persisted in keeping the writeoff periods so long that business investment has been discouraged.[9]

It will be evident that these controversies have really been much ado about nothing except for their serious consequences, and they can and must be quickly

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[7] Included in the unanimous recommendations of the Labor-Management Committee of Jan. 10, 1975, was the recommendation for an increase in the investment tax credit and a recognition that additional tax measures are needed "to foster . . . the growth of capital formation to produce jobs."

[8] Consumption taxes as a percentage of total taxes collected: United States 17 percent; France, 35 percent; West Germany, 27 percent; Japan, 20 percent. The VAT has been adopted by all the nations in the European Economic Community. These nations rely less on income taxes and more on value-added taxes of the "consumption" type. Unlike the income tax, the VAT puts a penalty on high-cost production and permits a 100 percent writeoff of capital costs in the first year.

[*] Studies by economist George Terborgh analyzing the overstatement of corporate earnings resulting from historic-dollar accounting show that adjusted retained earnings of all nonfinancial corporations in the United States were $34.0 billion in 1967 as compared to $28.4 billion in 1973, and $18.4 billion in 1974. Adjusted retained earnings were $15.1 billion in 1967 as compared to $4.7 billion in 1973 and $8.1 billion for 1974.

[9] The Government first intruded in an important way in 1934 when the Treasury at the behest of Congress arbitrarily reduced all depreciation allowances 25 percent across the board to increase the revenues to fund depression programs (Treasury Decision 4422). Congress was adamant on increasing tax rates at the bottom of the depression, and seized on reducing depreciation allowances as an alternative.

The exigencies of wartime production in 1940 and 1950 forced the enactment of 5-year amortization to eliminate the shortages of facilities and the industrial obsolescence that had resulted in considerable part from the unwise tax depreciation policy adopted in 1934. The "need for capital investment to get the economy moving again" prompted President Kennedy at the beginning of his term to adopt the investment credit and more realistic depreciation guidelines to get rid of the restrictive depreciation tax policy that had persisted all the years since 1934.

resolved so as to encourage the investment that the nation needs. It is also very clear that the differences will not be resolved by a lot of name-calling and by mistakenly labeling the shorter writeoff periods of the Asset Depreciation Range System and the accelerated depreciation methods as "loopholes," "windfalls," and "subsidies." This only intensifies the economic illiteracy and ignorant bias against capital and profits.

INVESTMENT DEPENDS ENTIRELY ON MAKING THE RISK REASONABLE

The plain fact of the matter, which seems to be constantly overlooked is that in reality there can be no realization of profit until capital costs have been recovered. Businessmen simply cannot get bogged down in the abstruse refinements of accounting theory involved in the somewhat artificial and always controversial accounting and reporting for financial and tax purposes.[10] They must be reasonably sure that they can recover their cost in the foreseeable future and make a reasonable profit on their investment after taxes.

With all the uncertainties and risk-taking involved today in capital investment (due principally to rapid technological change (obsolescence) and inflation, no one can precisely determine in advance (or even predict) the appropriate period or periods for the tax writeoff of capital costs.[11] Thus doubts must be resolved to encourage the investment the nation needs.

If too long a period of writeoff is required by the Government, involving unacceptable risks for the businessman, then the investment will not be made. If a tax credit is provided to make up for the inadequacy of the tax writeoff period and the impact of inflation, the investment may or may not be made, depending, of course, on the amount of the credit.

This does not involve any question of "loopholes" or "windfalls"; it is simply a matter of recovering capital costs against the income they produce over a period that will justify the investment.

TAX STRUCTURES OF OTHER NATIONS ENCOURAGE INVESTMENT

Other nations are well aware of this, and they have been entirely pragmatic and realistic in legislating very short writeoff periods for the costs of productive equipment to make certain of replacement and modernization. For example, Canada now permits a statutory writeoff in two years. Other industrial nations have abandoned controversial and outmoded accounting concepts for simple and liberal "capital recovery tax systems." [12]

As already mentioned, they give their tax officials almost complete administrative latitude to allow the writeoffs necessary to make certain the investment is made. The result is that their writeoff periods are much shorter than those in the United States, and even shorter than they appear to be from reading their statutory provisions.

Machine tool distributors sell and service a majority of all the machine tools installed in the United States. Thus, we know from the many exhaustive discussions we have had with hundreds of our customers, and from outside marketing surveys, the reasons why they have not been able to invest in the facilities necessary to reduce obsolescence in their plants and increase productivity. The principal reason, given to us over and over again, is the inadequate cost recovery allowances in the tax structure which discourage and even preclude facility investment.

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[10] The accountants themselves do not agree on depreciation policy and practice. Some oppose and others defend "straight line depreciation," "accelerated depreciation methods," "price-level depreciation," "replacement-value depreciation," the "standardized ADR system," "individualized depreciation lives," *et al.*

This controversy and confusion among accountants has largely been responsible for the confusion and unreasonable restrictions in depreciation tax policy.

The Secretary of the Treasury strongly criticized the "public relations bookkeeping" sanctioned by accountants for the resulting erosion of profits that has been hidden from the stockholders, the public and even management itself. It is high time the accountants resolved their differences and put their house in order.

[11] Numerically controlled machine tools that were the wonders of the world just five years ago are obsolete today and must be replaced with more sophisticated and higher cost machines.

[12] The "capital recovery system" proposed by Congressman Joe D. Waggonner, Jr., in H.R. 8226 is not unlike some tax systems adopted by other nations.

RECOMMENDATIONS

1. The additional first-year depreciation provided in Section 179 should be continued with an increase in the $10,000 ceiling to $100,000.

The present $2,000 allowance is almost ridiculous. If the first-year allowance is to have its intended effect, it should be at least $20,000. Section 179 was enacted principally for the purpose of encouraging and assisting small businesses to modernize their facilities so as to increase their productivity and become more competitive, lower cost producers. At the time Section 179 was originally enacted, most small businesses were using single-purpose machine tools that cost much less and were much simpler than the multi-purpose automated machine tools they must use today to stay competitive. The price of these modern machines is many times that of the old single-purpose machines.

Today it is not unusual for a small company to have to make an investment of as much as $100,000 in a machine as compared, for instance, to $10,000 in earlier years. Actually, some highly automated, multi-purpose machine tools required by small companies cost as much as $300,000 or even more today. Small companies are often required to make an investment in a single machine that is the equivalent of their entire net worth.

Thus, if Section 179 is to accomplish its purpose of encouraging and helping small business to modernize and become more competitive, the ceiling and the first-year allowance in the statute must be very substantially increased.

2. The accelerated depreciation methods ("declining balance" and "sum-of-the-years-digits") provided in Section 167(b) should be continued.

There is, of course, almost complete unanimity among tax authorities that these accelerated methods must be available to minimize distortions in income because of the greater proportionate loss of value in the earlier years of use as a consequence of obsolescence and other factors.

This pattern of greater cost allowances in the earlier years is generally followed by other industrial nations, and their allowances in the earlier years are generally greater than those provided by Section 167.

If our present Asset Depreciation Range System were to be replaced by a simpler "capital recovery system" as proposed by many tax authorities, the greater loss of value in the earlier period must, of course, be recognized.

3. The investment tax credit should be continued and made a permanent part of the capital recovery tax structure with an increase in the rate to 15 percent.

There is a general recognition that the investment tax credit is necessary to make up for the inadequate depreciation allowances of past years as well as the inadequate depreciation allowances under the ADR system. The continuing high level of plant obsolescence, and the inability of U.S. industry to modernize and replace to reduce this obsolescence and increase productivity, make it clear that not only must present depreciation rates be increased, but the investment credit rate of 10 percent must also be increased to assure the investment in productive facilities that is so urgently needed. This committee recognized the need for an increase in the investment credit in 1975 by incorporating a 12% investment credit into the Senate version of the Tax Reduction Act of 1975. It is our conclusion, based on our studies and the unanimous views expressed by users of machine tools and other machinery, that an increase in the investment credit to 15 percent (coupled with the proposed liberalization of ADR) is necessary to provide the assurance of adequate investment.

The credit to be effective must be a permanent part of the tax structure. As an on-again-off-again allowance, it makes long-range planning and long-range investment impossible. Enacting the credit for a four-year period, as the House did in H.R. 10612, is a step in the right direction, but a four-year period in much too short to encourage long-range planning and projects. Because of the long lead time on heavy machinery and the long periods required for many project completions, the availability of the credit should be a certainty at the time of order or project commitment. Utilization can be deferred to the year of payment or installation.

4. The Asset Depreciation Range (ADR) System should be continued and liberalized.

Although the ADR is somewhat complex and involves some additional expense in record-keeping, it is a basically sound approach for determining *depreciation* allowances. We emphasize the word "depreciation" because the ADR is not adequate to provide full capital cost recovery.

The guideline lives of the ADR have a sound statistical basis in industry studies and surveys, and they most certainly do not constitute "loopholes" as has so often been charged by those who really do not understand the ADR or the consequences of its repeal.[14] Actually, the ADR is not nearly as complex or formidable as it is represented to be by its critics—although it does involve some problems for small business. Whatever complexity the ADR does have stems principally from the conscientious efforts of its drafters (in which they generally succeeded) to fine-tune the depreciation allowances to traditional accounting concepts of depreciation and "generally accepted accounting principles." This was a difficult task since leading accountants themselves have serious disagreements over depreciation practices and applicable accounting principles.

The ADR does not ignore the obsolescence factor, as has been contended by some of its critics; but it is fair to say that it does not take obsolescence fully into account.

Standing alone, it clearly does not provide a sufficient capital cost allowance to assure the investment required to reduce obsolescence to acceptable levels. The 20 percent optional variation should be increased to 40 percent as recommended in 1970 by the President's Task Force on Business Taxation.

If U.S. industry is not to be at a competitive disadvantage with foreign industry, it is necessary for the U.S. Government to provide overall capital cost allowances comparable (or even greater because of our higher labor costs) to those allowed by other industrial nations. Although traditionally the United States has been reluctant to pattern its tax structure after those of other nations, the time may have come when we have no choice. We no longer have that self-sufficient wholly independent national economy we once enjoyed.

5. The alternative is a greatly liberalized and simplified capital recovery tax system.

If the investment credit and the ADR are not be amended as proposed, the time has come for a complete restructuring of capital cost tax allowances. The entire structure of tax allowances for capital investment costs must be greatly liberalized and simplified. Like so many areas of the Internal Revenue Code, the capital cost allowance provisions have become much too complex and technical, and too difficult to understand and apply. Their utilization also involves a wholly unacceptable level of increased expenses for the taxpayer, as well as for the Internal Revenue Service in the audit of tax returns.

To solve all these many problems; we recommend that the most careful consideration be given to eliminating from the tax structure, as other nations have done, all the intricate and complicated depreciation provisions that have been included to meet the many refinements of accounting theory. In their place the Congress should adopt a few simple and readily understandable provisions "capital recovery allowances" along the lines of those provided in H.R. 8226. These allowances can be expressed in fixed percentages sufficiently high, or fixed writeoff periods sufficiently short, to assure the risk-taking investment the nation requires. Five years for machinery and equipment and 15 to 20 years for buildings would almost certainly assure the requisite investment that the United States so badly needs.

6. The special investment problems of small business must be recognized in tax revision to encourage modernization and replacement of production facilities.

The highest level of obsolescence is generally to be found in the plants of smaller companies. This is the principal barrier to effective competition with their larger competitors who have better access to the capital markets for funds to modernize and replace their facilities.

Generally speaking, the erosion of profits due to the impact of taxes has been more severe for small companies than for their larger competitors. For example, they live under the constant threat of revenue agents to impose the Section 531 penalty tax on the accumulation of earnings beyond $100,000. In view of the tremendous increase in the cost of machine tools and other production facilities,

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[14] Some of the opponents of ADR who criticize its standardized guideline lives as loopholes," and advocate a return to the "physical" and "useful life" experience of the individual taxpayer do not understand that this would be a disaster, particularly for small business. Depreciation allowances would once again depend on the decisions of revenue agents on audit. This wholly arbitrary and outmoded system, which places an impossible burden of proof on the taxpayer, particularly the small company, was thoroughly discredited and condemned by the Kennedy Administration in 1962 and by every Administration since.

as already pointed out, it has become necessary for small companies to accumulate very substantial amounts of earnings over an increasing number of years to fund the facility investment required to stay modern and competitive. With the costs of machine tools and other machinery and equipment now running in the range of $200,000 to $300,000 and even $500,000, the $100,000 ceiling on earnings accumulation is unrealistically and unreasonably low. It should be increased to not less than $300,000.

H.R. 10612 extended the $50,000 surtax exemption and the 20% tax rate on the initial $25,000 of the taxable income for two additional years. While this is certainly a step in the right direction, the ravages of inflation and the erosion of profits due to tax policy require that the exemption be increased from $50,000 to $100,000, and that it and the tax reduction be made a permanent part of our tax laws.

* * * * * * *

One final word must be said to those who would oppose revision of the tax structure to eliminate deterrents to investment and to increase capital recovery allowances because of the loss of revenue. We hasten to add that we are also concerned about revenue losses at a time when the Government is faced with deficits running to $100 billion for the 1975 and 1976 fiscal years. But we are convinced that the problem of deficits cannot be solved by taking the short-range view. Although there will be a short-term loss of revenue, a longer term increase in the revenues from these tax proposals is a certainty. Increased investment that will increase productivity, sales, profits and employment will also inevitably increase the revenues from both corporations and individuals. This has been the history of taxation in the United States.

Senator BYRD. The final witness will be Dr. Martin Gainsbrugh, economic consultant, National Dividend Plan.

STATEMENT OF DR. MARTIN GAINSBRUGH, ECONOMIC CONSULTANT, NATIONAL DIVIDEND PLAN, ACCOMPANIED BY HAL SHORT, CONSULTANT TO THE NDP

Dr. GAINSBRUGH. Thank you, Mr. Chairman.

I particularly appreciate the opportunity to review with you the outlook for private capital formation as I see it and then the contribution the National Dividend Plan could make toward the stimulation of capital formation.

My name is Martin Gainsbrugh. For 30 years I was chief economist and senior vice president of the conference board. I also taught economics at NYU for the same period. For the past 3 years I have been acting as consultant to the National Dividend Plan. I am accompanied this morning by Mr. Hal Short who is also consultant to the NDP.

I would like to review briefly with you in view of the time limits the way I appraise the outlook for capital formation and then underscore for you how the NDP could help increase private investment. I propose to build my comments solely around the summary and the eight points contained in the summary because of the pressures of time.

The first point I would make is that we are well launched into an economic recovery after one of the steepest, most prolonged, and most widely dispersed recessions in my lifetime. Progress thus far has been good. What disturbs me and virtually every other student of economics is that after the end of the first year of recovery when we would normally look for a turnaround in investment in plant, equipment, homebuilding, and inventories, that has not yet transpired. Again, in my studied judgment, were this to develop, we should be embarked on

perhaps the longest peacetime period of expansion we have experienced since World War II. Without that turnaround in capital formation, this recovery could come to an end with the rate of unemployment still at 7 to 7½ percent.

I cite the most recent Commerce Department survey taken in January which notes that business spending this year will again decline in real terms, the third successive annual decline in real investment.

By way of further documentation, on page 4, I cite the findings of the U.S. Department of Commerce as to the level of business fixed investment we should have from now until 1980. That analysis indicates that business fixed investment to achieve full economic recovery and full employment should reach 12 percent per annum and then I underscore for you from whence we begin. Instead of 12 percent, the latest figure is that business fixed investment in the fourth quarter of 1975 was 9.7 percent rather than 12 percent.

Obviously, if we are to reach full economic recovery and full employment, the rate from here on to the end of this decade ought to be more than 12 percent just for that particular purpose.

Finally, to demonstrate that this can be done, I underscore for you the unused human potential and the unused industrial potential that we have as we go into the second year of recovery. Our Nation's factories are operating at around 80 percent of capacity. They could go as high as 90 percent or 93 percent of capacity without straining our resources.

We have 7 million to 10 million people actively seeking employment and failing to find it.

On page 13, I think you would find it highly graphic to look at the chart just released in "Business Conditions Digest" showing this Nation's economic potential and then the actual position of the economy relative to that economic potential.

We are operating fully $200 billion—in 1972 dollars—below our economic potential as we go into the second year of recovery. This, then, is an all-too-brief review of the testimony I offer relative to the need for stimulation of private capital formation if we are to achieve full economic recovery.

I then move on to how the National Dividend Plan could assist in this drive to stimulate private investment.

At the bottom of the summary I outline all too briefly the major characteristics of the national dividend plan. One is that Federal corporate income taxes would be rechanneled from the public sector to the private sector. I also underscore double taxation of corporate dividends would be eliminated, unlike other recommendations, at the personal level, rather than at the corporate level. And for those who are interested, we present an attachment containing a full seminar discussion of the merits of exempting dividends at the corporate level versus exempting them at the personal level.

We also review rather critically in another attachment Secretary Simon's recommendations as they relate to the integration of corporate and personal taxes.

Moving on to how the national dividend plan would be of help to this committee and to the Congress: First, the national dividend plan would free dividends from Federal personal income taxes. We present estimates in our testimony as to what this would mean in the way of

increased investment, increased capital outlays and increased job creation.

But far more important than that, in light of the discussion that took place here earlier, is what the NDP would do to deter the continuance of Federal deficit.

Senator CURTIS. I have picked up an even later figure than yours as to what the Federal deficit for this fiscal year is: $76.9 billion is the latest figure submitted for fiscal 1976 and in prospect $40 to $65 billion for fiscal 1977.

What the national dividend plan in my studied judgment would do would be to help create a popular constituency which would resist further resort to Federal deficit. How do you organize the American people so they will stump for restraint on Federal spending, rather than going along with the insistence of some that spending be steadily increased at the expense of deficits?

The greatest threat on the inflation front is the continuance of enormous Federal deficits. This is largely holding back private investment. The chief executive officers of our largest corporations have seen the unbroken record of excessive Federal spending, far in excess of tax revenues. The national dividend plan would evoke a national social contract that would invoke a ceiling on Federal expenditures.

By way of closing, I would like to take you to page 17 of my testimony.

On many of the inflation fronts we have made progress—on the price front, on the cost-push front, but on one front we have yet to even win a token victory. Business and investor confidence is still shaken by the habitual resort to Federal deficits. Furthermore, the availability of funds for private capital formation as recovery gains momentum is also threatened by the prior lien the U.S. Treasury will have on national savings in financing its deficit in the months ahead. It can get what it wants out of the savings stream. The private sector has to take the balance. As I indicated to you, we face the prospect of a deficit of $77 billion this year and $40 billion to $65 billion in the next fiscal year. Imagine the consequences if this recovery were to die and go into a recession when we are already spending at a rate of $50 billion or more above Federal tax receipts.

Senator BYRD. Thank you very much. Your time has expired.

I might say that a good many years ago, John Perry and, more recently, my longtime friend Ken Wells, spoke to me about this rather intriguing proposal.

Let me ask you this: You say under this proposal all Federal corporate income taxes would be rechanneled from the public sector to the private sector. That is some $40 to $50 billion.

Dr. GAINSBRUGH. That is correct.

Senator BYRD. How would the Government make up for that loss in revenue?

Dr. GAINSBRUGH. You will find I have developed two tables in my testimony dealing with the impact. If you will look at the index, you will see these tables are shown at 9a.

What we propose is that the NDP be phased in over a 5-year period. If you take the $40-billion figure you have mentioned in the first year we would take $8 billion for the National Dividend.

The way in which that would be financed is shown in table 2 on page 9b. It would be financed exclusively out of what is called the fiscal dividend. We will, in the course of the next 5 years, continue to experience an expansion in Federal revenues of substantial character. I use here the projections for the next 5 years that are contained in the Federal budget. This is one of the virtues of the new Congressional Budget Act. We now do get official projections for the next 2 years, short-term, and for the next 5 years, longer term. Those projections indicate that within the course of the next 5 years, Federal revenues, as projected, would grow from $300 billion currently to around $585 billion 5 years from now.

Senator CURTIS. That is based upon the present law?

Dr. GAINSBRUGH. Based upon the present laws. We contemplate siphoning some part of that each year for one particular purpose, that is, profit sharing with the American citizens who make it possible for the corporations to operate as effectively as they do through granting them the special permission and privileges that corporations possess. This is profit sharing on a national basis.

Another tie, Senator, that I think is much needed is that the NDP will also help to serve to stimulate the participation of the citizenry in our electoral process. You must register to vote in order to qualify for the National Dividend. It is shocking to recite to you that in 1974, only 39 percent of those eligible to vote actually participated in the electoral process.

These, then, are some of the side effects of the NDP.

I think, to John Perry's everlasting credit, he has been tireless in his efforts, as you well know, to develop and educate the general public in the virtues of NDP. He brought me in after I retired from the conference board 2 or 3 years ago to demonstrate its economic feasibility. Even without the multiplier effect, the tables show if NDP is spread out over 5 years, it can be phased in without doing any damage to the Federal functions.

Senator BYRD. Senator Curtis.

Senator CURTIS. I will be brief since the Senate is now in session.

With reference to your summary on the first page of your testimony, how do you define "fixed investment"?

Dr. GAINSBRUGH. Business investment in new plant and equipment and no more than that—structures and equipment. Another category would be homebuilding and inventory accumulation, but this is solely new plant and equipment.

Senator CURTIS. That would include replacement?

Dr. GAINSBRUGH. No, this is additional new capacity—well, in the sense that it would replace obsolete capacity, yes. But maintenance cost or capital outlays charged to current expense would not be in that figure.

Senator CURTIS. This year only 13 percent of the budget dollar comes from the corporate income tax. What you propose is to phase out that 13 percent over a period of 5 years?

Dr. GAINSBRUGH. Over a period of 5 years, yes, and we would put a 50-percent ceiling on the corporate tax so you could not push the National Dividend up by raising the corporate tax.

Senator CURTIS. If dividends immediately became nontaxable at the personal level, which you do not suggest——

Dr. GAINSBRUGH. We do suggest that it be at the personal level.

Senator CURTIS. Do you suggest that in the phase-in?

Dr. GAINSBRUGH. No, immediately.

Senator CURTIS. What would be the impact on Federal revenues?

Dr. GAINSBRUGH. We estimate revenues would be cut 2 percent, or around $6 billion on the personal level basis. Secretary Simon has come up with a figure of $12 to $15 billion on the basis of his integration of corporate and personal taxes.

Senator CURTIS. What do the total dividends amount to now in the country?

Dr. GAINSBRUGH. Rather than guess at it——

Senator CURTIS. You can supply it for the record.

Dr. GAINSBRUGH. With corporate profits before taxes around $100 billion, I would say $30 to $35 billion would be corporate dividends.

Senator CURTIS. Some of that is held by people who have the $100 dividends received exclusion and some is held by tax-exempt entities?

Dr. GAINSBRUGH. Tax-exempts are already tax-exempt once, so they would not benefit from exemption at the personal level.

Senator CURTIS. The first $200 of dividends received by a couple would be exempt.

Dr. GAINSBRUGH. That is why we come up with a much lower figure.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of Dr. Gainsbrugh follows:]

STATEMENT OF DR. MARTIN R. GAINSBRUGH, ECONOMIC CONSULTANT, NATIONAL DIVIDEND FOUNDATION

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CAPITAL FORMATION'S KEY ROLE IN THE LONG CLIMB TO FULL RECOVERY: THE NATIONAL DIVIDEND PLAN AS A MAJOR CONTRIBUTOR

We are now in the second year of recovery from the longest, steepest and most widespread recession since the Great Depression. The current recovery has the potential to be the longest period of peacetime expansion this nation has ex-

[1] These attachments were made a part of the official files of the committee.

perienced in a generation.[1] To realize that economic potential, this young recovery needs the sustained momentum provided by a strong upturn in capital spending for new plant and equipment, residential construction and inventory accumulation. Such capital investment has in the past built staying power into cyclical expansions after the initial recovery stimulus provided by an upsurge in consumer spending.

REAL CAPITAL OUTLAYS DECLINING

To date, the current recovery has not been the beneficiary of any marked surge in capital outlays. Indeed, the latest surveys of anticipated expenditures for new plant and equipment of the U.S. Department of Commerce suggest that such investment may be declining in real terms for the third successive year.

As of late January–February, 1976, business planned to spend 6½ percent more for new plant and equipment in 1976 than in 1975. Survey participants, however, expected projected goods prices would be rising by more than that rate. On this basis, it appears that investment in real terms will decline about 3 percent in 1976, after contracting by 10 percent in real terms in 1975.

This contraction is most pronounced in transportation, one of the major areas where business fixed investment must be greatly expanded to meet full employment goals by 1980. Planned capital spending would decline by 27.7 percent from 1975 to 1976 for air transportation; by 18.4 percent for railroads; and by 11.1 percent for other transportation. Unlike most other sectors, investment in transportation would still be declining in the closing half of this year, as compared with the opening half; for all industries combined, spending in the second half would be 1½ percent higher than in the first.

Clearly business enterprise is still hesitant about authorizing the volume of expansion of industrial capacity that would build staying power into this expansion over the longer term. Unless this tidal wave of private investment in new processes and more efficient technology is forthcoming, this recovery could shortly erode, leaving unemployment at 7 percent or more. The public's faith in the regenerative powers of the enterprise system would ebb, even more than it already has.

FIXED INVESTMENT REQUIREMETS, 1980

The limited response of capital outlays to the recovery to date stands in striking contrasts to this nation's fixed investment requirements for the balance of the 1970's. The latest estimate of the "capital that would be required to achieve a real output level presumed to be consistent with approximately full employment in 1980" is that prepared by the Bureau of Economic Analysis of the Department of Commerce.[2] Business fixed investment in 1973, prior to recession, represented 10.4 percent of the gross national product, and in 1974, 10.5 percent. This was about the level that also prevailed during 1965–1970. Throughout the first year of recovery, plant and equipment outlays shrank as a share of national output. For the full year they averaged 9.9 percent of the gross national product and by fourth quarter, 1975, had further declined to 9.7 percent.

BUSINESS INVESTMENT IN NEW PLANT AND EQUIPMENT

	1973	1974	1975	4th quarter, 1975
In current dollars (billions)	136.5	147.9	148.5	151.9
As percent GNP	10.4	10.5	9.9	9.7

[1] In the 23 peacetime business cycles that have been recorded in business cycle annals since 1854, the duration of expansion from trough to peak averaged 26 months. The longest peacetime expansion so recorded followed the Great Depression, March 1933–May 1937, 50 months. The longest peacetime expansion since World War II, came directly after the war, October 1945–November 1948, 37 months. The last expansion ran from November 1970 to November 1973, or 36 months.

[2] See the Economic Report of the President, January 1976, for further discussion of future capital requirements. The full study is available from the Bureau of Economic Analysis, United States Department of Commerce. For another equally detailed projection of capital requirements, see the charts and tables presented by Dr. William Freund, Vice President and Chief Economist, New York Stock Exchange, in "Capital Formation and Dividend Tax Reform," a Seminar sponsored by the National Dividend Foundation, Washington, D.C.

To achieve full employment by 1980, the Bureau of Economic Analysis concluded, business fixed investment would have to average 12 percent of the GNP from 1975–80. Since the ratios for 1975–76 fall well below this requirement, investment ratios even higher than 12 percent would be necessary for the remainder of the decade to supply the capital formation required to achieve a full economic recovery.

STIMULATION OF PRIVATE INVESTMENT THROUGH THE NATIONAL DIVIDEND PLAN

Fully a decade ago the founder of the National Dividend Plan, John H. Perry, Jr., had already begun to advocate adoption of the NDP as an effective instrument to promote increased public participation in the investment process. He was among the first to propose exempting corporate dividends from double taxation in the belief that this would stimulate a heightened flow of personal savings into equities.

Thruston Morton, then Senator from Kentucky and a long-time member of the Senate Finance Committee, in a lengthy speech, May 9, 1968, about the National Dividend Plan, on the floor of the Senate stated:

". . . The investment incentives in the national dividend plan are the 50-percent ceiling on corporate income taxes and elimination of the Federal income tax on corporate dividends, thus removing present double taxation.

". . . Removal of Federal personal income taxes from corporate dividends would have a stabilizing effect on the stock markets. Private citizens would invest in companies on the basis of their earning rates. The present speculative game of musical chairs to take advantage of the capital gains tax rate would be replaced by solid, long-term investment in earnings and growth." [3]

Such an exemption would serve to offset the excessive reliance upon debt financing, as well as attract more funds for investment in new plant and equipment, especially for small or growing business enterprises in need of venture or risk capital. Through the NDP a political constituency would be created that would lend its support for constructive measures designed to enable the corporate sector to operate more effectively; without such a constituency, proposals to integrate corporate and personal taxes die a lingering death from political anemia.[4]

ENDING DOUBLE TAX OF DIVIDENDS

Unlike other current proposals, NDP seeks the elimination of the double tax on dividends by exempting such income from Federal personal income taxes. Were dividends rendered tax exempt at the corporate rather than personal level, corporate directors would be under mounting shareholder pressure to take advantage of the tax-free status of dividends at the expense of what would otherwise be retained as undistributed earnings reserved for future growth and other contingencies. Last year, retained corporate earnings totaled over $40 billion; they have traditionally formed the reservoir tapped for expansion by growth enterprises. That readily accessible capital source would be diminished significantly, in the judgment of this observer, by this proposed tax exemption of dividends at ~~the corporate~~ level.

Tax exemption at the personal level is not without its accompanying problems. Political opposition would arise undoubtedly in certain quarters were the entire income of an individual to become tax-exempt through exclusive concentration of that individual's holdings in dividend-paying equities. Such exemption would be viewed as favoring the large rather than the small investor, particularly so since share ownership is more heavily concentrated among the upper-income groups. Foundations and other philanthropic institutions would not benefit directly from such a provision, since their income is already tax-exempt. On net balance, the overriding consideration is a pragmatic one; freeing dividends from taxation at the corporate level courts widespread opposition by the public in general that, rightly or wrongly, believes corporations rather than people pay taxes.

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[3] See Congressional Record, May 9, 1968, "National Dividend Plan Urged by Morton."

[4] See "Secretary Simon's Tax Program for Increased National Savings: Why It Lacks Political Feasibility," National Dividend Foundation, Washington, D.C., 1975.

ECONOMIC IMPACT OF DIVIDEND EXEMPTION

How significant a contribution toward closing the gap between the prospective need for investment and prospective savings would exemption of dividends from Federal taxes make? The estimate employed by NDP is indeed modest, compared with others in circulation; roughly 2 percent of Federal resources, we believe, is currently provided by Federal taxes on dividends received by individuals. Under the NDP assumption, individual income would thus be increased by about $6 billion free of Federal taxes, to be spent or saved at individual option. Secretary of the Treasury Simon places the revenue loss from dividend tax exemption at $12.5 billion–$19 billion.[5]

Still another estimate prepared by Congressman Jack Kemp of New York dramatically highlights the constructive economic impact arising from the exclusion of domestic corporate dividends from adjusted gross income.[6]

[Dollar figures in billions of 1974 dollars; employment in thousands]

Years after enactment	GNP	Private employment	Capital outlays	Federal revenues
1	20.9	1,200	$15.5	$0.6
2	28.7	1,510	16.3	3.1
3	35.7	1,740	17.0	5.3

The National Dividend Plan will contribute significantly toward the stimulation of private capital formation (a) through eliminating the double tax on dividends and (b) creating a popular constituency that will resist the resort to Federal deficits to underwrite the unbroken growth of the public sector.

Granted the desirability of the National Dividend Plan as an effective instrument in the national drive to secure the necessary investment to provide full employment, can we as a people afford the National Dividend Plan? In the light of the stickiness of unemployment and the inertia of capital formation thus far in the recovery, the question might be answered by another question: Can we afford not to?

ECONOMIC FEASIBILITY OF NDP

The accompanying tables are designed to demonstrate the economic feasibility of NDP, assuming the Plan were phased in over the next five years. These projections rely upon the estimates of Federal receipts and expenditures presented in the Federal receipts and expenditures presented in the Federal Budget for the period 1976–1981. By 1980 the National Dividend would total $52.7 billion and there would still be a $10 billion Federal surplus remaining for debt reduction or the lowering of personal taxes. The National Dividend by 1980 would yield about $750 to each registered voter in the last national election. (For further details on the NDP, see the attachment: "National Dividend Plan: A Viable Alternative.")

Federal expenditures in 1980, price indexed to 1976 as they would be under NDP, would total $460.6 billion. Federal revenues, however, would have grown to $470.4 billion, even after payment of the National Dividend. Thus, even after all corporate tax collections had been rechanneled from the public to the private sector, there would remain a surplus of $9.8 billion in that year, followed by a further surplus of $34.7 billion in 1981.[7]

By way of further substantiation of the feasibility of phasing in the National Dividend over the next five years, a similar analysis has been prepared (Table 2), in which the Budget projections of expenditures are accepted without change. (In Table 1, budget projections of expenditures are replaced by expenditures, price indexed to fiscal 1976, that is, assuming the same volume of outlays as in the base year, 1976.)

Once again the table illustrates it is possible to phase in the National Dividend over the next 5–6 years, without any impairment of Federal functions. By fiscal 1981, with the National Dividend fully implemented, Federal revenues would still top Federal outlays by $3.8 billion.

[5] From the Secretary's testimony before the House Ways and Means Committee, July 31, 1975.
[6] See Congressional Record, Dec. 3, 1975, "The Alternative to the Tax Reform Act."
[7] The Budget estimates assume that Federal receipts between 1976 and 1981 will about double "due to growth in the tax base and an increase in the average effective tax rate on personal income as rising real incomes and inflation move people into higher tax brackets."

TABLE 1.—FEDERAL EXPENDITURES, FEDERAL REVENUES AND FEDERAL DEFICIT-SURPLUS, ASSUMING NDP PHASED IN, 1977–81

[Fiscal years; billions of dollars]

	1976	1977	1978	1979	1980	1981
Line 1: Actual and projected Federal expenditures	373.5	394.2	429.5	455.7	482.5	509.9
Line 2: Federal expenditures, price indexed, 1976	373.5	396.7	420.9	442.0	460.6	479.0
Line 2A: Annual change, implicit price index	5.9	6.2	6.1	5.0	4.2	4.0
Line 3: Net reduction in federal expenditures	0	+2.5	−8.6	−13.7	−21.9	−30.9
Line 4: Federal corporate income taxes	40.1	49.5	54.5	59.8	65.9	71.7
Line 5: NDP, 5-year phase in	0	9.9	21.8	35.9	52.7	71.7
Line 6: Actual and projected Federal revenues	297.5	351.3	406.7	465.3	523.1	585.4
Line 7: Federal revenues less NDP	297.5	341.4	384.9	429.4	470.4	513.7
Line 8: Deficit—surplus after NDP (line 2 less line 7)	−76.0	−55.3	−36.0	−12.6	+9.8	+34.7
Line 9: Official budget surplus—deficit	−76.0	−43.0	−22.8	+9.6	+40.6	+75.5

Note: Line 1, "The Budget of the U.S. Government, fiscal year 1977," p. 28; line 2, line 1 adjusted by line 2A; line 2A, GNP deflator, percent change, year over year, "Budget, 1977," op. cit., pp. 25–26; line 3, line 1 less line 2; line 4, projected receipts by source, "Budget 1977," p. 29; line 6, "Budget 1977," p. 28; line 7, line 6 less line 5; line 8, line 2 less line 7; line 9, "Budget 1977," p. 28.

TABLE 2.—FEDERAL EXPENDITURES, FEDERAL REVENUES AND FEDERAL DEFICIT—SURPLUS ASSUMING NDP PHASED IN, 1977–81

[Fiscal years, billions of dollars]

	1976	1977	1978	1979	1980	1981
Line 1: Actual and projected Federal expenditures	373.5	394.2	429.5	455.7	482.5	509.9
Line 2: Federal corporation income taxes	40.1	49.5	54.5	59.8	65.9	71.7
Line 3: NDP, 5-year phase in	0	9.9	21.8	35.9	52.7	71.7
Line 4: Federal revenues, actual and projected	297.5	351.3	406.7	465.3	523.1	585.5
Line 5: Federal revenues less NDP	297.5	341.4	384.9	429.4	470.4	513.7
Line 6: Deficit—surplus after NDP (line 1 less line 5)	−76.0	−52.8	−44.6	−26.3	−12.1	+3.8
Line 7: Official budget surplus-deficit	−76.0	−43.0	−22.8	+9.6	+40.6	+75.5

Note: Line 1, "Budget 1977", p. 28; line 2, "Budget 1977," p. 29; line 4, "Budget 1977," p. 28; line 5, line 4 less line 3 line 6, line 1 less line 5; line 7, "Budget 1977," p. 28.

These estimates make no allowance for the increase in consumption and investment that would arise by the transfer of from $50 to $70 billion annually of purchasing power from the public to the private sector, under the NDP. State and local tax revenues would also benefit. The Federal sector would benefit, in turn, as thousands of individuals and families were raised above the poverty threshold through distribution of a National Dividend of nearly $750 per registered voter, or almost $1,500 per two-voter family.

In the final table, the NDP is projected back in time, retrospectively, assuming that the phase-in period began about five years ago. Had Federal expenditures been price-indexed as of 1971, they would currently total less than $300 billion or nearly $80 billion less than at present. The National Dividend distributed to the national registered voters would now total $40 billion with a like amount remaining for Federal debt reduction or tax relief.

NET REDUCTION IN FEDERAL EXPENDITURES AND FEDERAL DEBT UNDER NDP, ASSUMING PHASE-IN BEGAN IN 1972

[Fiscal years; billions of dollars]

	1971	1972	1973	1974	1975	1976
Line 1: Budget expenditures	211.4	231.9	246.5	268.4	324.6	373.5
Line 2: Federal expenditures price indexed, 1971	211.4	220.1	233.1	255.7	278.0	294.4
Line 2A: Annual change, implicit price index		4.1	5.9	9.7	8.7	5.9
Line 3: Net reduction, Federal expenditures under NDP		11.8	13.4	12.7	46.6	79.1
Line 4: Federal corporate income taxes	26.8	32.2	36.2	38.6	40.6	40.1
Line 4A: NDP, 5-year phase in		6.4	14.5	23.2	32.5	40.1
Line 5: Available for reduction Federal debt, after NDP distribution (line 3 less line 5A)		5.4	−1.1	−10.5	14.1	39.0

Source: Line 1, "The Budget of the U.S. Government, Fiscal 1977," p. 365; line 2, Line 1 corrected by line 2A; line 2A, "Economic Report of the President, 1976," p. 175; 1976; line 3, line 1 less line 2; line 4, "Budget 77," p. 358; line 5, line 3 less line 4A.

LITTLE THREAT OF BOOM AND BUST

Contrary to public impression, the recovery to date has been of modest rather than boom dimensions—with the latter usually embracing the fear of bust following boom. Webster describes an economic boom as "a sudden rapid growth and expansion, usually with an increase in prices." This expansion, as it enters its second year, has lacked the vigor of sharp upturns that developed in the first year of recovery following the recessions of 1954–55 or 1958–59. No quick return to full employment or a runaway boom is envisaged in the various econometric models, official or otherwise.

In past recoveries, real national output rebounded in the first year to match or top the preceding peak. This time the economy hasn't yet returned to the real output of late 1973:

[In billion of dollars]

Year or quarter	Gross national product — Current dollars	Gross national product — 1972 dollars
1973:		
3d quarter	1,319.7	1,236.5
4th quarter	1,352.7	1,240.9
1974:		
1st quarter	1,370.9	1,228.7
2d quarter	1,391.0	1,217.2
3d quarter	1,424.4	1,210.2
4th quarter	1,441.3	1,186.8
1975:		
1st quarter	1,433.6	1,158.6
2d quarter	1,460.6	1,168.1
3d quarter	1,528.5	1,201.5
4th quarter	1,572.5	1,215.9
1976: 1st quarter	[1] 1,617.0	[1] 1,235.8

[1] Estimate, the Conference Board.

The last peak of economic activity was reached in late 1973. Our population has bulged by another 4 million subsequently and almost a like number has been added to this nation's labor force. We've a long way to go to provide the same real output per capita attained in 1973, to say nothing of higher living standards to which each oncoming generation aspires.

The long road back to full economic recovery is well illustrated by the accompanying chart comparing America's potential gross national product with actual output presently. Note how much wider the gap now is than in any previous recovery in the past quarter century. As of fourth quarter, 1975, this recovery lingers nearly $200 billion below the country's full economic potential (in terms of 1972 dollars).

[In billions of 1972 dollars]

	Actual GNP	Potential GNP	GNP gap
1973: 4th quarter [1]	1,240.9	1,284.0	43.1
1975:			
2d quarter [2]	1,158.6	1,348.5	189.9
3d quarter	1,201.5	1,375.2	173.7
4th quarter	1,215.9	1,388.8	172.3

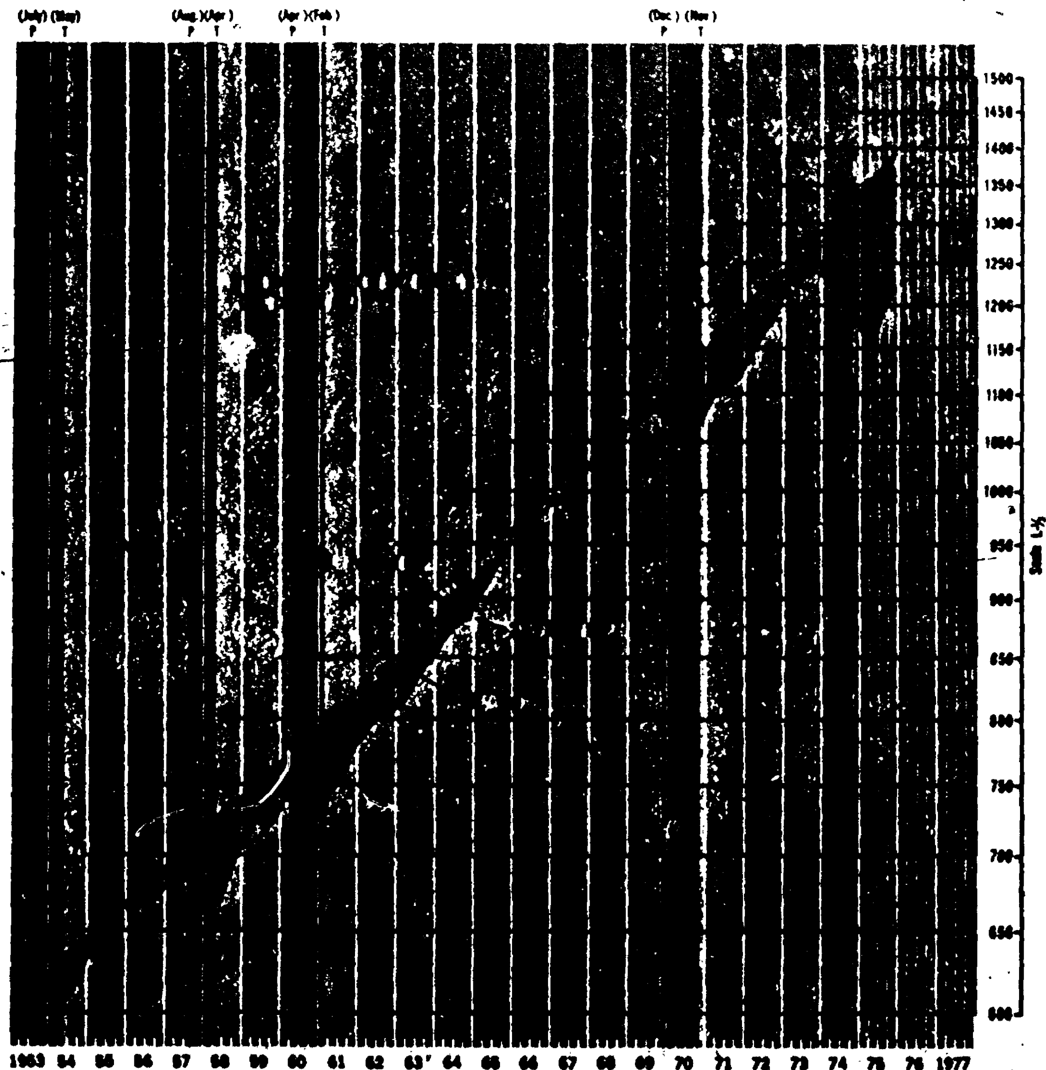
[1] Peak of last recovery.
[2] Onset of current recovery.

Source: Business Conditions Digest, Feb. 1976, p. 95.

What this approach strikingly portrays is that our national rate of economic activity, even after a year of recovery, lags about 12 percent below the nation's economic potential. Were the real growth this year, 1976, to average about 6 percent, the official projection for budget purposes, the net results would still leave us operating at roughly 10 percent below economic potential.[8]

[8] Potential economic growth is placed at 4 percent annually, 4th quarter 1968–4th quarter 1975. See Business Conditions Digest, Special Note on Potential GNP, February 1976, p. 95.

ACTUAL AND POTENTIAL GROSS NATIONAL PRODUCT



UNUSED INDUSTRIAL CAPACITY

By way of further documentation of unused potential, manufacturers as late as December, 1975 were utilizing only 79 percent of their capacity. Additional new capacity will be coming on stream in 1976–77. From seven to ten million individuals are currently actively seeking employment and failing to find it. Viewed against this backdrop of slack in both human and industrial capacity, the likelihood of any immediate resumption of double-digit inflation arising from demand in excess of supply seems remote, to this observer. Until such time as we appear to begin to approach our national economic potential, fiscal and monetary policy alike should be accommodative to stimulation of private capital formation to further economic growth, rather than neutral in its impact or, as a few already advise, restrictive. Should this expansion be brought to an end with unemployment still hovering at 7 percent or more, faith in the voluntary enterprise system in general and in the private sector in particular, would be sorely tested, if not abandoned.

PRODUCTIVITY UNIT LABOR COSTS AND PRICE STABILITY

Still another offset to the resumption of double-digit inflation is the contribution rising national output and mounting new investment makes towards gains in national productivity.

* Bureau of Economic Analysis, United States Department of Commerce, News Release, Mar. 22, 1976, Manufacturing Capacity Utilization Unchanged in December 1975.

Productivity improvement is more readily forthcoming in periods of expansion when volume rises than in contraction. Last year output per hour worked rose enough to offset wage increases of 7 percent–8 percent. In fact, unit labor costs in manufacturing at year-end were lower than at mid-year. That trend has undoubtedly continued in the opening months of this year:

1975:	
January	144.1
February	144.5
March	146.7
April	147.4
May	148.0
June	147.8
July	148.3
August	148.2
September	147.9
October	147.7
November	147.8
December	147.7
1976: January	148.0

Source: U.S. Bureau of Labor Statistics.

As unit labor costs stabilize, prices are in turn favorably influenced. Wholesale prices have remained virtually unchanged in the first quarter of this year. Consumer prices have been slower to respond to this restraint on cost-push inflation, but the latest figures reveal that prices paid by consumers are now barely above where they were at year-end: December, 1975, 166.3; January, 1976, 166.7; February, 167.1 (with 1967=100).

NDP AS AN EFFECTIVE RESTRAINT ON FEDERAL SPENDING AND ACCOMPANYING HUGE FEDERAL DEFICITS

Improved national productivity and investment incentives to expand supply in prospective shortage areas are helping to reduce the threat of another dose of double-digit inflation.

On another inflation front, however, we have yet to win even a token victory: [Business and investor confidence is still shaken by the habitual resort to Federal deficits. Furthermore, the availability of funds for private capital formation as recovery gains momentum is also threatened by the prior lien the U.S. Treasury will have on national savings in financing its deficit in the months ahead.] Despite a full year of recovery, we are told, the Federal deficit for this fiscal year will total about $76.9 billion. What compounds the inflation threat is the prospect of another $40–$65 billion deficit in fiscal 1977.

Several econometric models already have the current expansion tapering off by mid- or later 1977 (calendar year). The Chase Econometric Model, latest version, has the economy on the verge of recession by end-1977, in good part because of credit restraints invoked by the Federal Reserve Board to fight the renewed threat of double-digit inflation. By year-end 1977, Chase estimates the rate of national economic growth would fall to 2.7 percent and prices in general would be rising at an annual rate of 8.3 percent.

It is on this inflation front that adoption of the NDP finally provides aid and comfort to those who are disturbed, if not alarmed, by the acceptance of deficit financing as a national, if not worldwide, way of life. NDP offers as a reward to those concerned citizens the prospect of profit sharing in the future growth of this society, if they in turn will support a moratorium on new Federal programs at least until the Federal budget is again balanced. The quid pro quo exacted for the national dividend is a ceiling on Federal spending, except for allowance for the inroads of inflation. NDP would invoke a national compact or social contract between the people and their representatives in Congress that would slowly but steadily return solvency to Federal operations.

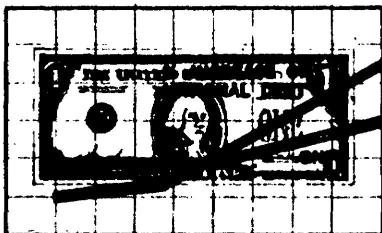
Given the assurance of relief from Federal deficits under the NDP, the willingness of industry and investors alike to provide the capital formation requirements needed to restore this nation to full economic health would be more readily forthcoming. The NDP recognizes that today's citizenry is now as conscious of the costs of government as it was initially of the benefits of government, when deficits were first invoked as weapons to fight the Great Depression. Once invoked, Federal deficits were accepted in periods of expansion as well as contraction; in periods of deflation as well as in years of inflation; in peacetime, as in war. Through the National Dividend Plan we can slowly begin to reverse this over-reliance on deficits and help rebuild our faith in the creative powers of the private sector and the voluntary market mechanism.

NDP

With each passing month the polls reveal the growing belief that the future of the United States of America is in jeopardy! This belief is now intensified by the visual and tangible evidence of a continuing inflation accompanied by serious unemployment after the longest, sharpest, widest recession since the great depression of the Thirties.

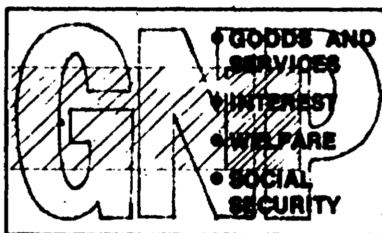
Few public officials who recognize this concern have been candid enough to admit the U.S. already experienced a mild though real step toward bankruptcy when it devalued the dollar.

And that devaluation occurred not once, but twice within fourteen months! Continuing Federal deficits have driven our national debt beyond half a trillion dollars. This, to the point that the drain of the debt now outpaces the annual growth of our Gross National Product.



The public sector spent over 500 billion dollars in fiscal 1975 alone, fully one third of our Gross National Product,

For the purchase of goods and services
For interest
For welfare
For social security



Borrowing by the Federal Government and its agencies now takes about sixty percent of all the funds raised in the private securities market!

The result?

Investment funds are far less available to the private sector, forcing many corporations to turn from traditional equity financing, to backbreaking debt financing.

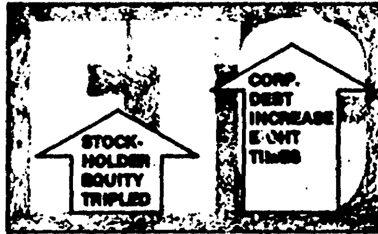
(Capital is essential, recession or not)

And how serious is this?

A Federal Trade Commission report covering a ten-year period states this:

> In manufacturing corporations with assets of one billion dollars or more stockholders' equity tripled.
>
> But, the total debt of these corporations increased eight times.

This extreme reliance on debt financing, both public and private is a threat to economic stability. This could topple our economy which has always been delicately balanced.

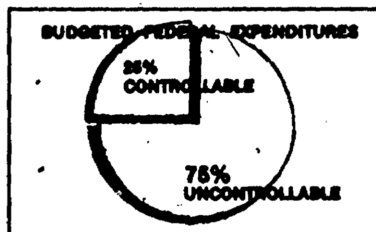


Witness the buying power, artificially expanded by deficit-financing and excessive increase in the money supply:

It drives up the cost of living so sharply that it forces more government efforts to control the economy.

These, in turn, create new political pressures, further economic distortions, and more inefficient and costly Federal programs.

Already, the costs of many existing Federal programs have soared beyond administrator control. And we know what is responsible: liberalized eligibility rules and increased benefits with built-in escalations ". . . up to 75% of budgeted Federal expenditures are uncontrollable because these obligations were spelled out and locked in by law for more than one fiscal year . . ." says Elmer Staats, the Comptroller General of the United States.



Each social program has its own administrative costs. Once started, few programs are discontinued. All become costlier each year.

The social planners put their emphasis on what they think the recipients should get, rather than what the economy can afford!

"Emphasize the benefits. Disregard the costs to the taxpayers." This is what they imply.

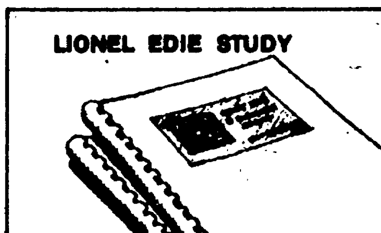
Extend these trends into the future and the consequence is an economy faced with diminishing returns . . . which could lead to total collapse. The people would no longer be able to support the demands of government.

For us to survive as a free nation, we must pay for our social progress out of earnings. As was emphasized by President Ford in his 1975 State of the Union message, "These programs cannot, however, continue to expand at the rates they have in the past two decades. Spending by all levels of government now makes up a third of our national output. Were the growth of domestic assistance programs to continue for the next two decades at the same rates as in the last 20 years, total government spending would grow to more than half of our national output. We cannot permit this to occur. Taxation of individuals and businesses to pay for such expansion would simply become insupportably heavy. This is not a matter of conservative or liberal ideology. It is hard fact, easily demonstrated by simple extrapolation. We must begin to limit the rate of growth of our budgetary commitments in the domestic area to sustainable levels."

We must get the voting citizens on the side of sound, business-like management of the Federal government and, simultaneously, appeal to their own self-interests.

The National Dividend Plan is designed to do this.

The Lionel Edie Company, a subsidiary of Merrill Lynch, concluded an in-depth feasibility study of the National Dividend Plan, with these words:



"The NDP Program which is designed to reduce the dependence of our economy on Federal government spending and allow private enterprise to regain its rightful role in determining the direction of economic and other activity is endorsed by us."

NDP is simple.
NDP is common-sense economics.
NDP is anti-recessionary.

NDP rejects inflationary demand created by Federal deficits and substitutes for it demand created by individual spending of real dollars earned in the private sector.

NDP recognizes that profitable productivity is absolutely essential to the nation's well-being.

NDP is based on the premise that profitable productivity is possible only through:

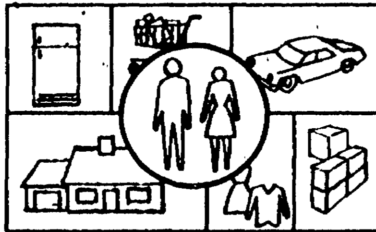
(1) An increased flow of investment dollars into the private sector and

(2) Adequate consumer buying power to purchase all that is produced.

A growing number of national organizations—deeply concerned about the future of our economy—are showing increasing interest in the National Dividend Plan. Among them:

The Conference Board.
The Committee for Economic Development.
The American Enterprise Institute.
The U.S. Chamber of Commerce.
The Black Silent Majority.
The National Association of Manufacturers.
The General Federation of Womens Clubs.
The United States Jaycees and the United States League of Savings Associations.

Moreover, nationally known economists and political scientists acknowledge its feasibility.



NDP combines:

Investment capital.
Production.
Profits.
Consumer buying power.

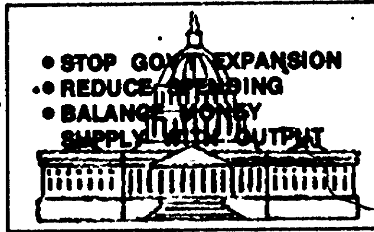
NDP is a total system to ensure economic stability by restraining booms and moderating recessions.

We all agree that we must give top priority to restoring the fiscal credibility of the dollar.

Here's how it can be done:
First, stop expansion of the Federal government.

Then reduce government spending as a percent of personal and business income.

Finally, bring expansion of the money supply into step with the growth in real output.



The National Dividend Plan can achieve this by paying out directly to individual consumers all corporate income taxes—rather than use them to finance further increased Federal spending.

NDP will thereby sharply reduce the necessity for increasing government programs.

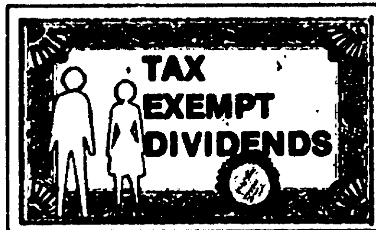
At the same time, NDP will encourage private efforts to earn more profits—an absolute necessity if we are to avoid national bankruptcy.

Simplicity is the appealing principle of NDP.

First, by imposing a ceiling of 50 percent on Federal corporate income taxes, NDP will stimulate investments, particularly in equities. The National Dividend Plan assures the investor that the rate—which will continue to be set by the Congress—cannot exceed 50%.

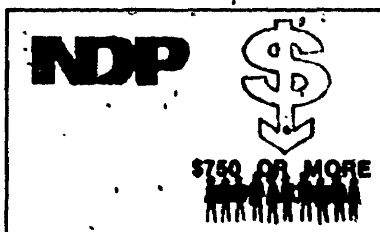
Federal corporate income taxes have ranged around 50% for the last quarter century.

In addition, NDP eliminates the Federal personal income tax on dividends.



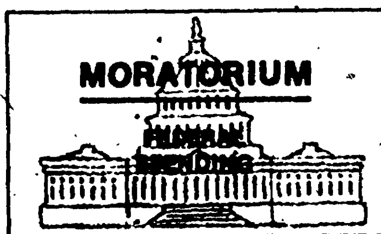
The Federal personal income tax on dividends is, in reality, a double tax, borne by nearly 40 million Americans who now own shares in corporations.

Second, NDP payments will be made quarterly to each registered voter, and will be free of personal Federal income tax.



Payments are estimated to exceed $750 per year per voter, at full implementation.

This amount can be substantially more as management and workers cooperate to achieve higher production and higher profits.



To prevent any disruption of the economy, or impairment of necessary Federal government functions, a strict moratorium is proposed on new, major Federal spending programs.

The Congress must tighten its grip on expenditures.

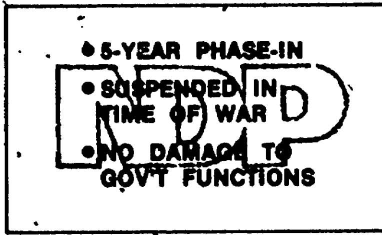
Present funded programs must be made to work for the best interests of our total society, not just for special groups—or they should be eliminated.

NDP funds will be distributed virtually cost-free. The U.S. Treasury will send quarterly checks to each state and the District of Columbia.

The States, in turn, will use local banks as depositories to distribute the checks to the individual voters in the various communities. The cost-free use of these funds by the banks, for short periods of time, will more than compensate them for their services.

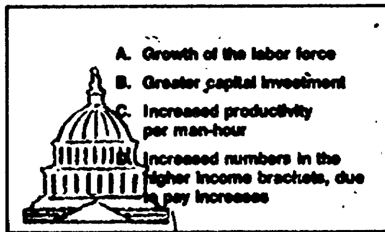
NDP's operation can be suspended by the Congress in time of declared war.

By phasing NDP into operation during a 5-year period, it can be funded at a rate of 20% per year without damage to any necessary functions of the Federal government.

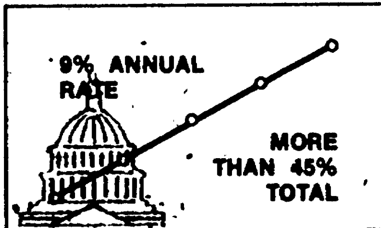


The long-term annual growth in Federal receipts, would continue to make this possible under NDP from these "build-in" factors:

A. Growth of the labor force.
B. Greater capital investment.
C. Increased productivity per man hour.
D. Increased numbers in the higher income brackets due to pay increases.

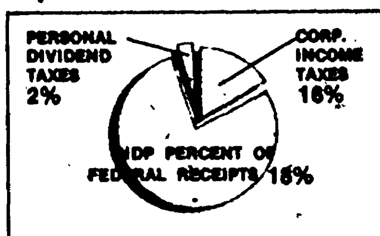


As to the Federal receipts, they have grown, during the last five years, at an annual rate of 9% . . . for a cumulative total of more than 45%.



Looking at the present Federal budget for 1976, one finds that corporate income taxes account for 16% of the total estimated Federal receipts. The exemption of dividend payments from personal income taxes comes to about 2% more.

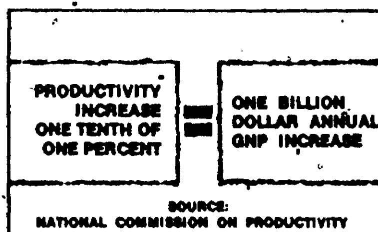
Therefore, about 18% of Federal receipts would be diverted to National Dividend Plan payments at full implementation.



But this is more than compensated for by the previously mentioned revenue increase during the 5-year phase-in period, even after allowance for the erosion of purchasing power through further inflation.

This substantial revenue cushion can cover escalations built into present programs.

Then, as the economic impact generated by NDP increases, political justification or need for a variety of other programs will be reduced, or vanish altogether! When this occurs, they too, could be promptly cut back or eliminated by the Congress.

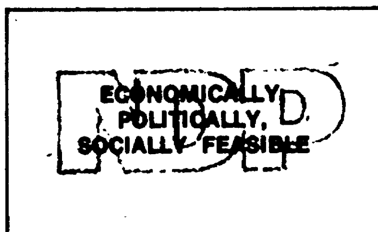


NDP's close link to profits will encourage emphasis on reducing rather than adding to costs, in both public and private sectors.

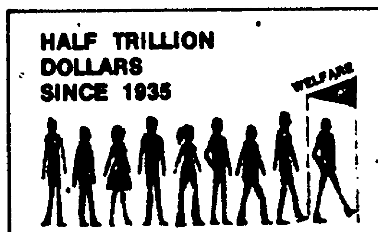
Further, the only way to keep unit labor costs from rising—and still satisfy labor demands—is to increase productivity. We can obtain the cooperation of the worker and the family toward this end by sharing the profits and thereby avoiding a serious polarization in our economy.

NDP makes the voting public an integral part of the profit motive—by giving it a share in the profits. In so doing our progress is funded by private rather than by public funds, and reduces reliance on deficit spending.

NDP is economically, politically and socially feasible. Through it, we can transform our profit and loss system into a political success and save it from political failure.

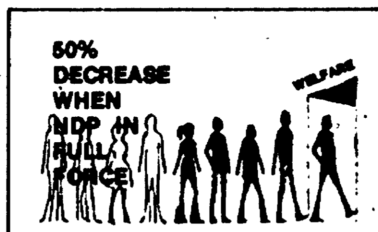


We have spent more than half a trillion dollars on welfare since 1935, and the problem is greater than ever.



While NDP is not a specific solution to the welfare and poverty problem, it does hold more promise in this area than any other proposal advanced so far.

The Edie Company found, in its earlier feasibility study, that a fully implemented NDP would lift more than 50% of the poverty families in America above the poverty level. Those remaining would be raised toward the escape threshold.

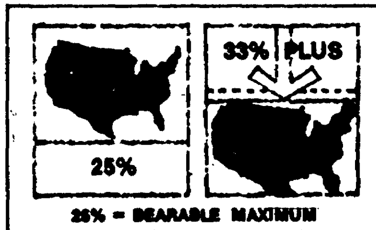


So, with more than 50% of these families out of poverty, the financial burden of welfare will ease, and the remaining hardcore cases will be more manageable.

The unfunded liabilities of the Social Security system further increase the probability of economic chaos, when added to the already strained financial condition of the country.

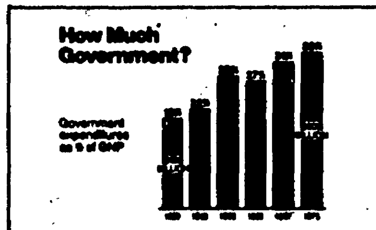
NDP enactment would be a partial substitution for the unfundable portion of Social Security, thus relieving the Federal government of commitments which, obviously, it is unable to keep.

By giving the voters a piece of equity in the country, we can pay for our security out of earnings without further worry that increasing obligated spending will bankrupt us.

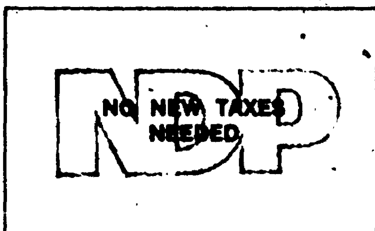


Total government spending in the United States now equals a third of our Gross National Product.

Colin Clark, a distinguished Australian economist, warned nearly half a century ago that as government expenditures advanced above 25 percent of a nation's total output, the resulting tax burden would become oppressive. Public officials who attempted to foot the bill through taxation would find that course of action politically unpalatable.



In consequence, once the 25 percent limit was passed, society would opt for inflationary financing rather than more taxes. Clark's "Law" was not given much professional endorsement when first voiced. But the universality of inflation in peacetime in the Western World currently lends strong support for this thesis of an upper limit to the proportion of output that can constructively be allocated to the public sector.



Stimulating the economy through the private sector has three basic advantages:

First, NDP will be funded by earned dollars . . . corporate income taxes. It will not require new or increased taxes. It changes the purpose and the method of distributing these tax collections. And NDP uses a distribution process which is completely efficient and equitable.

Second, payments will go directly to the individual voters, thereby targeting the funds where the people and their problems are concentrated.

Third, the economic activity stimulated by these direct payments will generate increases in State, County and Municipal sales, excise and income tax revenues, without raising tax rates.

With NDP fully implemented, this extra revenue will approximate the amount presently being disbursed annually under the revenue-sharing program.

The extra income from NDP—$1,500 or more annually for a man and wife, when fully implemented—will mean the difference between independence and public assistance precisely in the areas where it counts most:

Unemployed adults . . .
Senior citizens with fixed incomes . . .
Large families . . .
Working families with low incomes, and
The family heavy in debt

. . . all of whom suffer the most when hit by inflation, taxes, high interest rates, and unemployment.

On the other hand, those who do not require National Dividend payments to meet current needs can save, or invest the funds.

This along with exemption of corporate dividends from their present double taxation, will provide much needed stimulus to capital formation.

And this new investment capital will contribute to the further expansion, production and profits for our free society.

That, in turn, will create more corporate earnings for distribution via National Dividend payments.

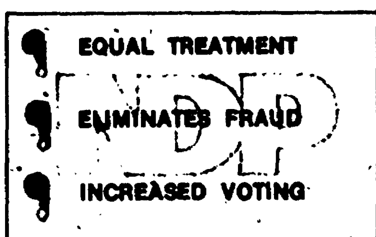
Use of voter registration lists for National Dividend payment distribution is based upon sound reasoning. First, voting records already are maintained in every community. There is no need for creation of a costly new agency.

Second, the voting system assures complete equality of treatment for all—without regard to sex, race, creed or national origin.
Political pressures and manipulation, as factors, are removed.

Third, by matching voter signatures in poll books with endorsements of National Dividend checks, tombstone and other fraudulent voting can be eliminated.

For the first time, the voter lists will be cleansed by a "double check" and on a national basis.

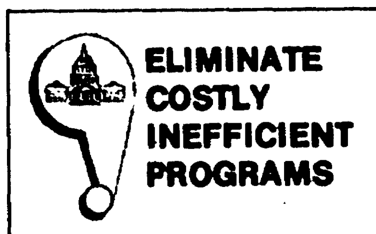
Fourth, with voting registration the basic requirement for participation in the NDP millions more will take part in this essential function, rather than the 38% who voted in the 1974 election.



There's a bonus, too.

By being equitable to all voters, the NDP will ease the discontent and divisiveness caused by social legislation which benefits special interest groups.

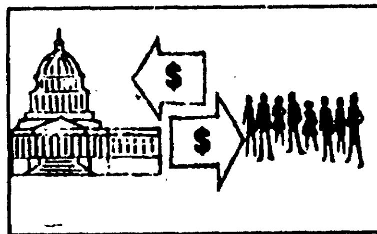
NDP will transfer the thrust of political pressure from the special interests to the people as a whole.



With this realignment of pressure, members of Congress will be more responsive to the general public. And a big majority of the voting public will support them in eliminating costly, inefficient programs, if NDP is there as an alternative and incentive.

Too many Americans view the Federal treasury as a free-flowing, inexhaustible fountain of funds, and benefits, but . . . the basic fact remains that the government must first take from the people everything it gives to the people.

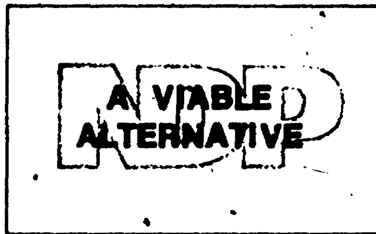
Most Federal spending is non-regenerative, with a low economic multiplier.



The bulk of the funds spent by government are not for the production of goods for the trade streams. The principal effect of this is to create demand in excess of the capacity of private industry and business to produce goods and services for the market place, with inflationary consequences.

In contrast, NDP involves only the distribution of earned dollars...... those taxed out of the earnings of the nation's corporations.

Earned dollars are real dollars.



NDP is a viable alternative . . . a new approach . . . a means to preserve our faltering profit and loss system.

We must stop borrowing from tomorrow.

We must stop living beyond our means.

We must stop spending money we have not yet earned.

Our almost unmanageable Federal government can be curbed . . . can be decentralized.

We can replace the waste and inefficiency in the Federal sector which have sapped our economic strength for years . . . with a policy which puts earned dollars into the hands of individuals, and lets them fill their needs as they desire, in the private marketplace.

We can give the electorate a stake in our economic system.

NDP will strengthen our free market economy.

NDP will generate more private funds for capital formation, with a ripple effect. And without such funds, corporations cannot expand . . . cannot modernize to remain competitive.

NDP . . . The National Dividend Plan is a progressive, new policy which builds upon—rather than destroys —our existing profit and loss system.

With NDP, we can move into our third century with enthusiasm restored, and with renewed confidence that a better life is assured for all of us.

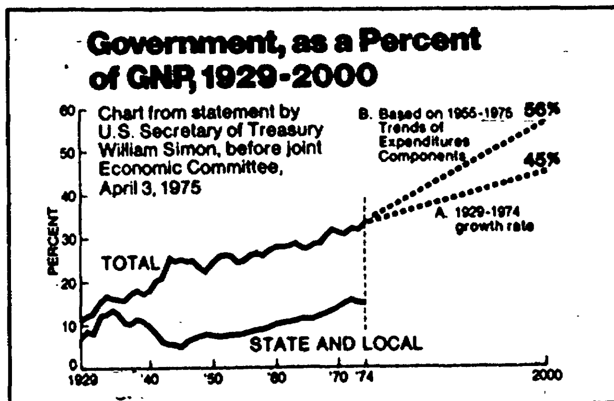
BY DIVERTING FEDERAL CORPORATE TAX COLLECTIONS TO THE ELECTORATE, NDP WILL ENCOURAGE VOTER SUPPORT OF OUR FREE COMPETITIVE ECONOMIC SYSTEM

The NDP imposes a 50% ceiling on corporate income taxes; it ends Federal personal income taxes on dividends received by individuals; it distributes the Federal corporate income tax to each registered voter, Federal tax free; it proposes a moratorium on major new deficit spending programs; and lastly, it is to be phased in over five years, to assure that no essential Federal function would suffer.

DID YOU KNOW—
FEDERAL, STATE, AND LOCAL GOVERNMENT WILL ACCOUNT FOR 80% OF OUR CAPITAL MARKETS MONEY REQUIREMENTS IN 1976?

"In fiscal years 1955-59, the Federal Government accounted for 20 percent of net funds in the capital markets; in fiscal years 1970-74, the Federal share grew to 45 percent. In fiscal year 1976, we anticipate that even with the moratorium on new spending and other spending control measures proposed by the President, total Federal borrowing will account for 68 percent of the capital markets, and if we add to that amount the anticipated borrowing by State and local governments, total government borrowing during the coming fiscal year will be 80 percent of the capital markets. Only 20 percent will be left to private industry in a financial market that has always been the centerpiece of our free enterprise system."

Statement of U.S. Secretary of Treasury William Simon on February 10, 1975, before U.S. Senate Finance Committee.



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Senator BYRD. The committee will stand adjourned until 10 o'clock tomorrow morning.

[Whereupon, at 12:20 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, March 31, 1976.]

TAX REFORM ACT OF 1975

WEDNESDAY, MARCH 31, 1976

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met at 10 a.m., pursuant to recess, in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Ribicoff, Byrd, Jr., of Virginia, Hathaway, Haskell, Curtis, Fannin, Hansen, Dole, and Packwood.

The CHAIRMAN. This morning we will call as our first witness Mr. Louis Kelso, managing director and chief economist, Kelso Bangert & Co., accompanied by Norman G. Kurland, Washington counsel.

I see you have a rather impressive statement here. We will print the entire statement in the record, but we will ask you to summarize your statement in your oral presentation.

STATEMENT OF LOUIS O. KELSO, MANAGING DIRECTOR AND CHIEF ECONOMIST, KELSO BANGERT & CO., ACCOMPANIED BY NORMAN G. KURLAND, WASHINGTON COUNSEL

Mr. KELSO. I would appreciate putting it in the record. I am afraid I would be here all week if I tried to read it.

To summarize my understanding of the committee's function today, I understand that it is taking testimony on tax measures to make the U.S. economy, including the fiscal affairs of our Federal Government and State governments, work better for the people.

We think you could not start a better point than to first identify the chief cause of trouble in the U.S. economy. Why doesn't it work well?

Our analysis of this problem is simply as follows: That the people with the unsatisfied needs and wants in our society lack the productive power to produce the income needed to satisfy these needs and wants. These are roughly 95 percent of our consumer units.

The people with the excessive productive power, the 5 percent of consumer units, who own virtually all of our productive capital, have no present or prospective unsatisfied consumer needs and wants.

This is a gigantic mismatch, but mass consumption is necessary to support mass production. A good economy is one in which every consumer can produce enough income to live well.

We cannot forget Aristotle's theory that the purpose of production is consumption. In the past we have had a defective economic policy. It held that we could solve all of our economic problems through full

employment alone. To the extent that did not work and it never did work except during wars, preparation for wars, and recovery from wars, then the purchasing power gap had to be closed by Government redistributing income extracted from the hard-pressed taxpayers or from ever deepening Government debt.

Thanks to the careful study of this committee the House Ways and Means Committee, the Joint Committee on Internal Revenue Taxation, the Joint Economic Committee, the Senate Commerce Committee, the House Interior Committee and their respective staffs and of many others the thinking of Congress is swinging away from this one-factor economic policy toward a policy of recognizing the necessity of solving our chief problem through measures that involve both factors of production.

The 1976 Joint Economic Committee report at pages 170 to 173 announces the conclusion of the Joint Economic Committee. The distinguished chairman of this committee Senator Long, sat as a guest on the hearings on ESOP financing held by the Joint Economic Committee last December. The 1976 Joint Economic Committee report announces the conclusion that the U.S. economic policy must be broadening to include encouragement of vigorous and effective steps to expand the capital ownership base. This is a striking, startling, and a terribly important turning point in the congressional thinking on this subject.

Under our past one-factor economic policy we needed to pay no attention to who owns the productive capital. We acted as though we could solve the income distribution problem with jobs and welfare, including boondoggle, of course, which is disguised welfare. The rich could go blithely on getting richer, the poor clamored only for jobs and welfare. Overall, our economy, all things considered, went from bad to worse over a period of 40 years.

Our proposals to this committee address themselves directly to the underlying economic problem, the concentration of the ownership of economic productive power, that is, of capital. They do so without impairing or threatening private ownership of present capital. They employ the self-financing logic that business has always employed for itself. Our proposals are designed to, first, return to the Government any brief intermediate revenue loss and then to perpetually increase Government revenues so that they do not lead to long-term deficit financing, and they build increased productive power into those who need it rather than those who do not.

Our proposals include certain negative recommendations to the Congress. These are among them.

Please avoid measures that while they may solve one problem like aiding the financing of new capital formation, they may create an even worse problem by making the rich richer and keeping the poor propertyless. Such solutions do not solve the consumer's income problem while creating insoluble debt problems and other economic problems for Government—in other words, the irreversible deepening Federal debt.

We recommend that Congress be very circumspect in considering measures to stimulate capital formation without constantly asking the question: Who will own the newly formed capital?

We are confident if Congress will enact the measures outlined in our testimony, it will set the U.S. economy firmly on the road toward generating two or three decades of legitimate full employment, arresting and shortly afterward reversing on a permanent basis our destructive inflation and bringing about the steady hardening of the purchasing power of money, accelerating the rate of growth of the U.S. economy to unprecedented high levels, 10 to 15 percent per year, building broad capital ownership into every U.S. ownership, that is, every individual and family, giving us the basis for a foreign policy whose primary objective, whose primary weapon is showing our neighbors how to become prosperous and self-sufficient, subordinating our military prowess, without imparing it, to secondary importance. Force should not be our first line of foreign policy.

It will begin shifting the emphasis in Government economic policy from attacking the effects of poverty to attracting it because—the low productiveness of the individual or family that does not own a viable holding of technology embodying productive capital.

Finally, it will begin restoring fiscal integrity to our currency and our Government because each of the measures we urge involves building the productive power that quickly increases national income, personal incomes and, finally, national tax revenues and makes possible the reduction of national debt and, in due course, the reduction of taxes.

Each of the measures herein urged is either immediately revenue-producing or will at worst, cause a few years of revenue reduction followed by total Government recovery of those revenue losses and thereafter a continuous increase in Government revenues.

We urge that this committee and the Congress look for the hidden flaws in the proposal that are being made in this area. The measures urged in our testimony are free from the flawed productivity argument; namely, that increased incomes to labor can result from accelerated new capital formation without eroding the rights of property. There are only two factors of production and you cannot have labor taking out more while putting in less without eroding the rights of the other factors.

It is simple mathematics. Under conditions of labor redundancy which have long prevailed, wage and salary increases in return to no increase in productive input by labor either led to higher costs, which is the engine of inflation——

The CHAIRMAN. I will have to ask you to end your oral presentation at this point, Mr. Kelso. I think some members want to ask questions.

Senator HATHAWAY. As I understand your plan, Mr. Kelso, it would put the stock in the hands of employees and deduct the cost of the stock. Would this apply to closed corporations as well as those listed on the stock exchanges?

Mr. KELSO. Senator, there is a wide variety of ESOP financing, putting stock directly into a trust is just one of them. It does have application to every kind of corporation and every kind of business. We have used them in service and manufacturing enterprises.

Senator HATHAWAY. It seems to me in many businesses the value of the stock is difficult to determine and you would not be giving the employees in many situations anything at all.

Mr. KELSO. Senator, we have asked among the measures that are listed and in bills attached to our testimony that a no-action procedure similar to that used by the Federal Trade Commission for over half a century and by the SEC for some 40-odd years that a no-action procedure be set up so parties to a transaction can come in, lay their evidence and valuation studies before the Internal Revenue Service and get an advance ruling.

Today the posture of the law is such that the taxpayer must sort of walk into and ambush. He must choose the transaction and then if the Treasury thinks the value is wrong, he is in trouble. Of course, then follows lawsuits and all that sort of thing.

The Treasury's attitude in the past is that they wouldn't give advance rulings on valuations because in general they don't give rulings on questions of fact, but valuation is not a question of fact. It is a question of opinion.

There are really three opinions that are important—the buyer, the seller, and the Treasury. Until the buyer and seller get together, you don't have a problem. We think our proposal for an advance ruling would then solve most of the difficulties as it now stands. The Treasury simply will not approve a valuation in advance and they have the power to burn you at the stake if you sell it for more than it is worth.

Senator HATHAWAY. Would you agree if they can't put a valuation on it, the company can't put up a plant?

Mr. KELSO. They can set up a valuation. They have to have a careful study made by a qualified appraiser. The Treasury is constantly studying firms held by people who die. It is a relatively common thing.

We would like to take the risk out of it.

Senator HATHAWAY. Death is the end of the road. In this type of situation you could get three people running a corporation who really want to get out and they can't find anybody to buy their stock, so they set up ESOP and plan to get out two years later and they borrow against the stock, and when they get out because they are the ones running the corporation, the stock becomes valueless and the employee is left with nothing except a lot of paper that is not worth anything.

Mr. KELSO. It is almost impossible for that to happen, Senator. The bankers are steely-eyed, and if the loan is approved by the bankers, the value is there or the seller takes the risk that it will pay for itself. If it pays for itself, it is not a valueless business, so the odds of that happening are terribly remote.

Senator HATHAWAY. By the time they get the loan, the company is worth something because it then is continuing to work.

Mr. KELSO. Then you put the employees in the position where they can make it valuable and any intelligent human being put in the position where he can make his investment more valuable, he will do it. You can count on his aquisitive instinct. For example, in the case of an asbestos mining company up in the Vermont area they made it profitable by trimming their wages and cutting out things and tightening up their practices.

Senator HATHAWAY. My point is the employees may not know how to carry on the business after the key men get out.

Mr. KELSO. It needs good management, but the employees are the managers, too.

Senator HATHAWAY. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. I want to reflect on Mr. Kelso's statement. I will pass for the moment to ask other questions. I have to leave here at 10:30 to testify before the Judiciary Committee, but I will be back in about 15 minutes.

The CHAIRMAN. Mr. Kelso, is employee stock ownership inflationary?

Mr. KELSO. Senator, I believe it is deflationary.

The CHAIRMAN. Would you mind explaining why?

Mr. KELSO. Yes. We urge and take steps to actually assure that the design of an ESOP is such that the capital pays for itself within a reasonable period of years. That is the logic of it. Once it pays for itself, the tools continue to throw off goods and services into the economy.

An excess of goods and services chasing a limited amount and diminishing amount of credit is exactly the definition of inflation. There is another aspect to it of deflation. As long as we have left the labor force in a position where it owns no capital and its cost of living is going up and its taxes are going up, then it has no choice except to demand more and more pay for less and less work, and we can't blame this on the worker. He can't roll over and play dead. So he forces inflation on the society.

ESOP financing puts him in the position where, if he demands more pay for less work, unreasonably, he is impairing his own investment. I think we can rely on the commonsense of the American worker that he wouldn't do that. He wants to retire economically self-sufficient and he can't do that unless he makes his investment valuable.

The CHAIRMAN. In the example of the Vermont and South Bend cases, if they own a piece of the action, they are willing to take a pay cut, work harder and longer and try to make the concern survive. Isn't that right?

Mr. KELSO. That is exactly right. That is the logic of it.

The CHAIRMAN. I have been somewhat amused having these fellows before the committee advocating get-rich tax schemes. I am not against the rich getting richer, but I agree with you that if those people don't want to go the route of England, they are going to have to learn that there are other people who would like to own part of the action.

We gave them 7-percent investment credit. That did not cost them a penny. Most of them couldn't get around to picking the cash off the floors for the workers. People who have so little concern for their workers lead me to understand why workers hold them in such low regard.

It would seem to me that if we want management and business to work together, we had better recognize that they ought to work for the common good of all rather than on this hog-it-up basis, because these people are asking for a 12-percent investment tax credit or 15 percent and they haven't given the workers 1 percent, which would not have cost them a cent except for the cost of setting up an ESOP plan.

That old-fashioned robber baron-type economics is pretty badly out of style even if those people have not learned it yet. I am pleased to see you advocating your concept.

Mr. KELSO. Senator, no one could say it better than that. You phrased it beautifully.

The CHAIRMAN. You have convinced one Senator.

Mr. KELSO. There is an extraordinary example on the west coast. One of the largest oil companies in the country adopted an ESOP for just its 1-percent investment tax credit. That is all. A stockholder demanded that they put in their proxy statement the proposal that they install an ESOP to handle only part or appreciably all of their $600 million a year financing. Management recommended against that.

This tells me that the investment tax credit by ESOP should be conditioned; at least 50 percent of it being capitalized and going to the workers. A $8.4 billion gift from all taxpayers to the rich, the 5 percent who own the corporations, is simply unthinkable. We are killing ourselves. We are destroying our economy.

The CHAIRMAN. Making the rich richer.

Mr. KELSO. Exactly.

The CHAIRMAN. If these people don't learn that the workers are very important, and that they ought to do something to make their workers feel kindly toward them then 20 years from now it may not make any difference whether they know it or not.

Mr. KELSO. That is exactly right. Twenty years ago I had a conversation with the chairman of a large corporation and I said you had better begin financing your organizations in the Middle East so you build a broad ownership with the natives because someday they will take away every stitch of it.

Down in Florida a few days ago they took away every stitch.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Mr. Kelso, take a relatively small company with relatively few stockholders. How would your plan work and would it not have the effect of changing the control of the corporation?

Mr. KELSO. Senator, most employee stock ownership plans are installed with full recognition that while everyone should be an owner of productive capital because technology is gnawing away at the adequacy of the labor power of everyone, they also recognize that management is a tough, difficult art. At the very moment the worker has a chance to become, over a working lifetime, a substantial owner, he is in a position where the quality, the experience, the expertise of the management is more important to him than ever before in his lifetime. Therefore, most trusts involve the voting of stock by a group appointed by the board of directors.

Now, as a practical matter, they have the alternative of passing the vote through the trust to the work force as well. In those cases where the vote is passed through, with proper education, workers understand the importance of management. In major trusts like that of Sears, Roebuck where the vote has been passed through for many years, in almost every year with one or two exceptions, the management at the annual meeting gets a higher support through the proxy machinery operated by the trust than they do through the proxy machinery operated by the public.

Senator BYRD. I see no problems with the larger corporation, but I wonder if the smaller corporations face a problem; namely, that it

could change the control of the corporation from one group—I am not speaking of employees now—I am speaking of one group of owners to another group of owners.

Mr. KELSO. In our experience the effect, Senator, has been to preserve a continuity of management. Down in your State there is a fabric manufacturer by the name of Halmode Corp. in which the original founder got up in years and sold to their employees. The company has been enormously successful. They trained the younger people to come on and the older generation is retiring. It is a method of creating a succession without the phenomena behind the title of that book written several years ago, "Welcome to Our Conglomerate—You're Fired."

Senator BYRD. I think it is a very intriguing idea.

Do not most of the large corporations have similar proposals or plans?

Mr. KELSO. Few large ones that have been installed except in some closely held corporations like Hallmark Cards. There is a firm with sales of somewhere over a billion dollars, about a billion and a half dollars, owned by the senior Mr. and Mrs. Hall. They have set up an arrangement so that some 60 or 65 percent of that corporation will be acquired by the employees.

I might say except for that, the only ESOP's set up for major corporations were adopted to take advantage of the 1-percent tax investment credit. Mr. Pettigrew will be testifying here today. He represents a large Texas corporation, not one in the super-billion-dollar class, but still about a quarter of a billion dollars in sales. His company is now about 25 percent owned by its employees. In 2 years its economic condition has enormously improved.

Senator BYRD. Thank you.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

On page 58 of your statement you say the issue of ownership versus control is a delicate one and with a small corporation we recognize that and you say "especially where unions are involved." That seems to be one of the barriers to the ESOP plan, to be able to work with the unions satisfactorily. I know that many times they are insisting on certain conditions existing that make the plan almost unworkable. What has been your experience in that regard?

Mr. KELSO. I believe, Senator, the union view is changing and changing pretty rapidly. In the first place, the National Maritime Commission ~~union has~~ come before the Congress and testified favorably toward the concept before the Maritime Subcommittee. In the case of South Bend Lathe Co., 95 percent of the workers were members of the steelworkers and the steelworkers union raised no objection there.

Senator FANNIN. Wasn't that company just about to go under?

Mr. KELSO. They were about to be broken up and sold. They were marginal. It was a matter of saving their jobs. It was also a matter of making more profits because they were owners.

Senator FANNIN. This is all tied together. Their jobs are tremendously important to them and I certainly do not fault the program. I have been very much sold on the program.

Mr. KELSO. You have been a key sponsor and introduced the first bill.

Senator FANNIN. I am concerned about having a plan that is successful. We have not had what I would call the success we anticipated. I will grant you we had success, but many of us anticipated this would be accepted on a basis that would give widespread——

Mr. KELSO. It will move much faster and we just have not had that.

Senator FANNIN. I have been told, not necessarily by you but by others, that we should work out some program where the unions would be supporters of the program rather than placing a barrier in the program.

Mr. KELSO. I believe that a union that understands the program will support. It is just inevitable. It stands to reason that the purpose of the union is to aid in the economic betterment of the lives of its members. If there are really two factors of production, not just labor, but the nonhuman factor, and if technology is making one of those factors less and less important and the other factor more and more important, which is the case, then the union that fails to seek to build capital ownership into its workers, I think, is doing less than half of its job.

It may be doing only a tenth of its job. I believe when the union wakes up, it will become a main educator of the working people on the art of acquiring, husbanding, taking care of, and protecting capital estates.

Senator FANNIN. You are giving a good argument for the rank and file union member, but I am not sure you are giving a good argument from the standpoint of the union official.

Mr. KELSO. I think the union official will have a bigger job. He has the most gigantic educational job on his hands in history of mankind.

Senator FANNIN. Understand, I am seeking ways of overcoming some of the problems we have and getting the ESOP plan involved in many companies rather than a few.

Mr. KELSO. I realize that.

Senator FANNIN. I would like to know how this can be better done, whether it requires legislation, whether it can be done just by proper management of the program or just what can be done?

Mr. KELSO. Certainly the leadership of Congress is terribly important. I think it is terribly important that the Joint Economic Committee the other day said, "Our economic policy has to be enlarged to include creating broad capital ownership."

The other measures that we have laid before you and that we hope that you will scrutinize carefully and act upon favorably, I believe, will make the ESOP so irresistable the unions cannot hold out against them.

Senator FANNIN. Thank you.

The CHAIRMAN. Senator Haskell?

Senator HASKELL. It is good to see you here. I don't know whether you remember it, but our daughters met when they graduated from college and you made a point of it by bringing a particular fine brand of whisky.

Mr. KELSO. It was rather unique on that occasion.

Senator HASKELL. Mr. Kelso, I certainly like your idea. I agree with you wholeheartedly when you say we should broaden ownership of productive capacity. The only question I would like to ask you and

it is probably because I don't understand the technicalities of it, I think one thing we want to be sure of is that, in fact, the ownership is with the individual employee. I wonder how you react to the provision, I believe, that you put it into a trust.

If an employee leaves, he does not necessarily take the stock with him, or, if he dies, his stock will be bought out by the company. I may be wrong on my facts, but I think it is very, very important that this be true ownership and not a trust in effect controlled possibly indirectly by management with the real ownership not passing out into the broad spectrum of people.

Can you comment on that? I may have my facts wrong, but can you comment on that general problem?

Mr. KELSO. As the law stands now, Senator, the trust is absolutely required to deliver the company stock to the employee at his termination of employment or disability, if he retires or dies.

We have urged in one of the measures before you that the law be changed so that at the request of the employee, before he retires, in cooperation with the trust committee, that the trust committee be enabled to diversify his portfolio. Often in the discussion of this subject the so-called prudent man rule comes up and the general concept of the prudent man rule is that it requires diversification. This happens to be a gross error.

There are two prudent man rules. One is the rich man's prudent man rule, which was laid down by the Supreme Court of Massachusetts in 1830. This is a rule as to how to keep a rich man rich, how a fiduciary should act to keep a man rich and optimize his income. It was overlooked for many years that there is a poor man's prudent man's rule and that is to put all your eggs in one basket and watch the basket very closely.

If you look around and read a book like Gustaf Meyer's "History of Great American Fortunes" or look at the rich families to your knowledge, they all got rich under the poor man's prudent man rule.

This makes sense, but it does require personal delivery. Under our bill it would be either the company stock or it would be the portfolio of the employee's selection.

Senator HASKELL. The individual employee would be able to get the company stock even if he left and there would be no option to repurchase.

Mr. KELSO. The Treasury now prohibits such an option. It could require the trust to buy it back if he wanted to, but that is up to the employee. The options are all in the employee's favor.

Senator HASKELL. Thank you very much.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Mr. Kelso, how many ESOP's are there in the United States.

Mr. KELSO. In 1970 the Treasury stopped counting them.

Senator RIBICOFF. What is your estimate?

Mr. KELSO. My estimate is somewhere in the vicinity of 250, maybe 300. It is terribly small compared to the number of companies. It is minuscule. We need some powerful stimulants.

Senator RIBICOFF. What would you say is the value at the present time?

Mr. KELSO. This is a wild guess, but perhaps $1 billion.

Senator RIBICOFF. You have a variation of what you are proposing in West Germany and Sweden, do you not?

Mr. KELSO. No, Senator. It is something that looks like it, but it is almost its opposite. That is the codetermination movement, which is along German and Belgian lines and which is largely being applied throughout the European Economic Community and in Great Britain. The codetermination movement involves labor's sitting on the board of directors and controlling the corporation, but it does not build capital ownership into the worker.

Senator RIBICOFF. In other words, in the West German system where they have something to say about management, they don't acquire ownership?

Mr. KELSO. If they acquire it, they acquire it by the same techniques which unfortunately have been used around the world for the last century, namely more and more pay for less and less work. This destroys private property and capital and is exactly the opposite of ESOP financing.

We think that the European Economic Community is moving toward the worst of both possible worlds. They are going to get amateur management on the one hand, and now ownership on the other, so it leaves them in the position where they still have to demand more and more pay for less and less work.

If the United States will change its economic policy to a two-factor policy—and this is what the Joint Committee has now indicated it should do—and if the Congress will strengthen the incentives as we urge in the 10 measures that we talk about in our written testimony, then I think the United States will have the highest production, the highest employment, the highest personal incomes with the lowest cost products of any country on earth, and the European Economic Community will have the rest.

They had better build tariff walls or we will take their markets away from them.

Senator RIBICOFF. The productivity in West Germany today probably exceeds any other country in the world. Just reading the headlines, apparently all currencies in the world are in trouble with the exception of the deutschemark, so their system is working.

Mr. KELSO. They are struggling with inflation, and their rate of capital formation is down, but it is greater than ours, but you have to take a look at the German character. It is one of industry. Germans will work in a slave society. We found that out during World War II.

Americans will work only in a free society with the proper incentives. We think the proper incentive—the American economic dream is a dream of being willing to work very hard all your lifetime, but to have something to show for it at the end, and ESOP does that. It enables the man to become economically self-sufficient.

Senator RIBICOFF. In these ESOP's with which you are familiar, the larger ones, do the employee-owners have representation on the board?

Mr. KELSO. Yes; even where the stock is voted by the committee, the board of directors have put representatives of the people in the shop on that committee. I think that is true in almost every case.

Senator RIBICOFF. Are there any in Connecticut, do you know? If there is, would you please let me know?

Mr. KELSO. I know I put on a seminar at the Hartford National Bank because they are very enthusiastic about it, and they think many customers should have them.

Senator RIBICOFF. Would you write me a letter on that?

Mr. KELSO. I have.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Thank you, very much. I have no questions.

The CHAIRMAN. Senator Dole?

Senator DOLE. I have no questions. I am in the process of reading your brief statement.

The CHAIRMAN. I would like to make an observation in answer to one of the questions that I think I can answer better than you can. Why did not more companies take advantage of having the 1-percent tax credit benefit more employees? The answer is that we drafted the provision so tight, with such severe regulations to back it up to avoid abuse, that the companies found all sorts of technical problems.

I have had some people write me that they went into it in good faith and the amount of legal expenses was more than they had to put up. In the case of A.T. & T., they showed technical problems. They said they would like to go into it, but they needed four technical amendments, which I think you would favor.

The same thing is true with regard to electric utilities generally. They would like to do it, but they had the same problem American Telephone & Telegraph Co. had. Others say the provision is effective for 1 year and they don't want to get their employees built up to think it is something great and then have it come to an end.

Others say it does not amount to enough. It means only $35 for the shareholder for the first year end after that you don't know if they are going to continue that provision or not. If there is something more substantial or permanent, all right, but for that small amount you would build employees up to big expectations and then they would be disappointed.

Another reason is that it is about the last thing on Earth the labor unions would want to ask for because they feel if the employees became shareholders, they might side with management next time they want to take them out on strike. So it involves a great number of things, gears and various and sundry reasons for being unwilling to try something new.

I have read that 600 companies have gone into it since we passed that provision of the tax law.

Mr. KELSO. Senator, this will interest you. I was talking to the head of one of the main unions in the country, which has 600,000 members, Mr. Kurland and I were. He listened for hours—I was making another brief statement. He said, "You know, I have spent the last 6 weeks trying to figure out how we could discharge our duty toward our members and not demand more pay for less work." He said, "I know it is going to ruin our economy and you have told me what the tradeoffs are. I think it is great."

So it is coming.

The CHAIRMAN. I know the difficulty of getting organized labor to overcome their fears. Traditionally, has not employee stock owner-

ship been regarded as something which has been employed by management to discourage the organization of labor unions?

Mr. KELSO. Impressions like that have been obtained, but there is no evidence to support it. The oldest ESOP, the first one I did in 1956, is in a newspaper which has six unions. It is enormously successful, they are happy as they can be—Peninsula Newspapers, Inc., which publishes the Palo Alto Times and Redwood Tribune. They threw out featherbedding and such rules. They said we can't afford this because we are throwing away our money, but all unions are still represented and this is 20 years later.

Senator DOLE. Have you gone back and done any studies? Do the voting habits of these people change any? This may be a way to preserve the two-party system. Everything else has failed.

Mr. KELSO. I know your chairman once told a group of businessmen if they did not begin to build some capital ownership into their workers, that the Republicans were going to go on the endangered species list.

Senator DOLE. They are the only minority not protected by the Civil Rights Act.

Senator BYRD. May I ask one question? Are you familiar with the Kansas City Star?

Mr. KELSO. Yes, sir.

Senator BYRD. How does your proposal differ from the Kansas City Star?

Mr. KELSO. It would have been about ten times as efficient. It would have done it faster, simpler, and it would have gotten ownership into all the employees, not just certain ones.

I might say that the Denver Post in Denver, Colo. is also employee owned, but they did it in a way in which only part of the employees got ownership and in which they spent something like $50 million more in taxes than they would have, had they done it right.

Senator BYRD. The Kansas City Star plan has been rather successful?

Mr. KELSO. Yes, sir, even one like Sears can be enormously successful even though it is perhaps only half as efficient as it could be. Another example, Northwest Industries which sold to Chicago Western Railroad—the president of the railroad came out of Arthur Anderson and was close to the chairman, who was a close friend of mine.

I wrote a letter explaining how they could do it and do it very efficiently. They didn't do it. They sold it in such a way that 9 percent of the workers owned all the stock. Later I found out what was in their mind: They had a secondary offering, that is to say, the 9 percent sold some of their stock to another 9 or 10 percent who wanted to get in on the act, as it were, and made several million dollars so that it was a scheme for a few people to get rich at the expense of their fellowmen.

That is not going to change the economic pattern in the United States. As a matter of fact, it will exacerbate it.

Senator BYRD. Thank you.

The CHAIRMAN. Senator Packwood, do you care to ask any questions?

Senator PACKWOOD. I think not. Thank you.

The CHAIRMAN. Thank you very much. We are very pleased to have had you before our committee today. I hope that others who have

dedicated their lifetime to advocating something they thought good for the country will profit from your example and eventually something may come of it.

[The prepared statement of Mr. Kelso follows. Oral testimony continues on p. 1481.]

TESTIMONY BY LOUIS O. KELSO, MANAGING DIRECTOR AND CHIEF ECONOMIST, PATRICIA HETTER, PRINCIPAL, AND NORMAN G. KURLAND, PRINCIPAL AND WASHINGTON COUNSEL, OF KELSO BANGERT & CO. INCORPORATED, INVESTMENT BANKERS

SUMMARY OF PRINCIPAL POINTS

THE STAGE HAS BEEN SET FOR THE EXPANSION OF NATIONAL ECONOMIC POLICY TO COMPREHEND BOTH FACTORS OF PRODUCTION

Substantial impetus has just been given to the past efforts of this Committee, the House Ways and Means Committee, the Joint Committee on Internal Revenue Taxation, the Senate Commerce Committee, the Joint Economic Committee, and other important Senate and House Committees to encourage business and labor to accelerate the rates of growth of new capital formation, broaden the base of capital ownership in the U.S. economy, and reduce the historic tendency of the U.S. economy to make the rich richer, and keep the poor propertyless. This impetus is the recent publication by the Joint Economic Committee in *THE 1976 JOINT ECONOMIC REPORT*, pages 170–173, announcing its conclusion that the U.S. economic policy should include the encouragement of vigorous and effective steps to broaden the capital ownership base.

The thinking of the Congress is swinging away from the belief that all our major economic problems—inadequate growth rate, unworkable income distribution, inadequate financing for new capital formation, and of inflation—can be solved through trying to achieve full employment, and towards solutions based upon two-factor economic principles. Primarily these are means to stimulate the rate of growth of new capital formation, to reduce the cost of financing that growth, to maximize the broadening of the base of ownership of capital and to minimize tendencies which make the rich (the excessively productive) still richer.

ELECTION YEAR GOOD NEWS MAY INFLUENCE CONSUMERS, BUT THE FATAL STRUCTURAL FLAW IN THE U.S. ECONOMY REMAINS AND MUST BE ELIMINATED

The quadrennial good-news machine is running full speed; consumers are taking heart that our depression is bottoming out and that they can safely spend more on consumption. But the serious structural flaw that assures our economic collapse or our succumbing to all-powerful government to prevent it, still remains. There is a gigantic mismatch between the possession of the economic power to produce goods and services (or their income equivalent) and the possession of unsatisfied needs and wants. The productive power represented primarily by the ownership of capital, is owned by people who have no unsatisfied needs and wants, present or prospective. And the needs and wants that make up the vast markets for the output of the U.S. economy are those of the 95% of consumer units who own no productive capital. It is our opinion that either we set about speedily curing this awesome structural flaw, or the grimmest chapters in American economic history lie immediately ahead. The U.S. economy is headed for the disaster already closing in on the British economy.

The legislative recommendations herein made to the Committee are simple, direct, and should have the least disturbing impact on existing institutions in the economy of the changes capable of putting the U.S. economy firmly on the road to self-renewal and to setting a shining example for the rest of the world's economies to follow.

We are confident that if Congress will enact the measures outlined in this testimony, it will set the U.S. economy firmly on the road towards:

Generating two to three decades of full employment;

Arresting and shortly afterwards, reversing, on a permanent basis, our destructive inflation and bringing about the steady hardening of the purchasing power of money;

Accelerating the rate of growth of the U.S. economy to unprecedented high levels—ten to fifteen percent per year;

Building broad capital ownership into every U.S. consumer unit (individual or family);

Giving us the basis for a foreign policy whose primary objective is showing our neighbors how to become prosperous and self-sufficient, subordinating our military prowess (without impairing it) to secondary importance;

Shifting the emphasis in government economic policy from attacking the effects of poverty to attacking its cause: the low productiveness of the individual or family that does not own a viable holding of technology-embodying productive capital;

Restoring fiscal integrity to our currency and our government, because each of the measures we urge involves building the productive power that shortly increases national income, personal incomes, and national tax revenues, and makes possible the reduction of the national debt, and in due course the reduction of all taxes.

EACH OF THE MEASURES HEREIN URGED IS EITHER IMMEDIATELY REVENUE PRODUCING OR WILL CAUSE SEVERAL YEARS OF REVENUE REDUCTION FOLLOWED BY TOTAL GOVERNMENT RECOVERY OF THE REVENUE LOSSES AND THEREAFTER BY CONTINUOUS INCREASE IN GOVERNMENT REVENUES

Our testimony reviews a micro-analysis of the effect on Federal revenues of ESOP financing and shows that while a temporary revenue reduction occurs during the financing period, total restoration of the revenue loss, followed by spectacular increases in government revenue results. The overall effect on the U.S. economy of the widespread use of two-factor financing techniques to accelerate the rate of growth in self-liquidating new capital formation can logically be projected from this example. For it would be but the cumulatve effect of the same phenomena taking place in many businesses, rather than merely in one. The rate of growth and the rate of use of these economic tools can be carefully controlled by the Federal government—primarily by the Federal Reserve Board. Thus the measures we recommend should be compared with all those legislative attempts over the past forty years to eliminate poverty by attacking its *effects* through granting subsidies and welfare that *never* return to the government their costs.

THE MEASURES URGED IN OUR TESTIMONY ARE FREE FROM THE FLAWED "PRODUCTIVITY" ARGUMENT THAT INCREASED INCOMES TO LABOR CAN RESULT FROM ACCELERATED NEW CAPITAL FORMATION WITHOUT FURTHER EROSION OF THE RIGHTS OF PRIVATE PROPERTY IN CAPITAL

Under conditions of labor redundancy, and these have long prevailed, wage and salary increases in return for no increase in productive input by labor either lead to higher costs of goods and services, or to diversion of the return on capital to the non-owners of capital. Quite obviously, the only way to avoid this is to make workers capital owners and to bring about a fuller payout of the "wages of capital."

THE MEASURES URGED IN OUR TESTIMONY ARE FREE OF THE FLAWED IMPLICIT ASSUMPTIONS THAT WE CAN SOLVE OUR PROBLEMS OF ACCELERATING NEW CAPITAL FORMATION THROUGH INCREASED "SAVINGS" BY CORPORATIONS AND INDIVIDUALS

The conventional financing of economic growth from internal cash flow or borrowings paid from internal cash flow, or by encouraging increased investment in enterprise by rich savers, all result in the further concentration of ownership of productive capital—the single flaw that lies at the heart of the U.S. economy. Through these conventional techniques, the rich get richer, and the 95% of non-capital-owning consumer units stay capital-less.

Similarly, measures which merely encourage individuals, through personal tax deductions or tax credits, to buy securities in the secondary markets, would boom up the business of the speculative securities industry, but they would not aid in the financing of the growth of business or in the significant broadening of the capital ownership base.

WE MUST NOT REDUCE CONSUMPTION TO INCREASE NEW CAPITAL FORMATION

Our testimony urges that the shifting in emphasis, so far as basic, well-managed U.S. enterprises are concerned, from the use of past savings (owned by

the rich) to the use of future savings, i.e. *pure credit*, is imperative, not only to speedily broaden the capital ownership base, but to prevent a slump in consumer demand, which invariably forces the government to become an ever-larger customer of business, purchasing things that do not compete for the consumers' dollar, like military hardware.

Any measure aimed at increasing the shifting of spending by the middle class and the poor from consumer goods into savings simply defies the double-entry bookkeeping logic of the economy.

OUR TESTIMONY EMPHASIZES THE IMPORTANCE OF SHIFTING FROM DEBT TO EQUITY FINANCING

But the specific measures we urge are designed not to make the rich richer (or poorer either) but to make the poor richer.

THE SPECIFIC MEASURES COVERED BY OUR TESTIMONY

(1) We urge that the investment tax credit be made permanent, but that at least half the credit be conditioned upon its being capitalized and the resulting stock deposited in ESOPs to assure the broadening of the capital ownership base. It is simply unthinkable that Congress, in an era of changing economic policy, will use its tax policy to the extent of more than 50% of the investment credit, to exacerbate the chief flaw in the U.S. economy by making the rich richer.

(2) ESOP and CSOP (Consumer Stock Ownership Plan—primarily for regulated public utilities) financing paper should be made discountable with the Federal Reserve Bank at a discount rate based on administrative cost, and the rate of interest charged by lenders on the paper discounted should be regulated to cover only lenders actual costs and reasonable profits in order to make credit available for the growth of basic well-managed U.S. enterprise and for broadening capital ownership at 2% or 3%.

(3) Dividends paid into ESOPs and CSOP escrows should be made deductible under the Federal corporate income tax laws. This is a method of "integrating" the personal and corporate income tax that does not merely make the rich richer.

(4) The present ceiling of 25% of covered compensation on payments into an ESOP should be removed, and an absolute ceiling of $500,000 per individual should be imposed on the maximum account an individual taxpayer can accumulate thereunder.

(5) ESOPS should be given the status of general purpose charitable foundations under the personal income, estate and gift tax laws in order to enable the rich, when they must eventually part with their wealth, to both return it to the tax system and to reconnect it with individuals who need productive capital in order to enable them to live better, be more secure, and to feel a part of the system, rather than to force rich individuals, as present law does, to socialize their wealth by putting it in general purpose charitable foundations. This would be an immediate revenue producing measure.

(6) Employee accounts in ESOPs should not be taxed when the accounts are removed from the trust at death or termination of service. The purpose of building capital ownership into individuals is to make them economically self-sufficient. Congress merely negates these efforts by taking away from the individual, at the very moment of his greatest need of the ownership of productive capital, up to 35% of that capital. The Federal government needs taxpayers with high incomes. The U.S. economy needs consumers with high incomes. The people need high incomes to live better.

(7) Present tax law and regulations should be amended to permit distribution of employee accounts in ESOPs in the form of diversified portfolios. The "poor man's prudent man rule" should be used to make employees rich, and then the "rich man's prudent man rule" should be used to protect the wealth they thus accumulate.

(8) The fiduciary duties applicable to ESOP transactions under ERISA should be clarified to avoid taxpayer confusion and misunderstanding.

(9) The Internal Revenue Service should be required to establish a "no-action" procedure to inform corporations and individuals of the Service's views on "valuation of securities" before transactions are concluded, rather than to further continue the "ambush" procedures under present law.

(10) The Internal Revenue Code should be revised to clarify the definition of an ESOP.

Introduction

GOALS OF THESE PROPOSALS

Our proposals for tax reform are aimed at achieving goals for the U.S. economy and for the nation that do not significantly differ, to the best of our knowledge, from those sought to be achieved by other witnesses, including the Administration's witnesses, who have appeared or will appear before this Committee. These goals are:

(1) To restore and to greatly accelerate the growth rate of the U.S. economy;

(2) To make possible the financing of new capital formation at sufficiently high levels and low costs to facilitate and maintain a high economic growth rate and to achieve legitimate full employment through the private economic sector;

(3) To reverse inflation and initiate long-term hardening of the dollar;

(4) To attack *the cause* of poverty by facilitating the building of significant ownership of productive capital and second sources of income into the U.S. private sector labor force and their families and eventually into all consumers;

(5) To protect the quality of our environment as the economy grows and to finance the new capital formation and jobs that growth will require;

(6) To increase the revenues of the Federal government without increasing tax rates;

(7) To expedite the achievement of self-sufficiency in energy by eliminating all institutional barriers to financing growth in energy-related enterprises, while lowering the cost of capital therein and building broad ownership of the resulting newly created capital into employees and into energy consumers without impairing their consumer goods purchasing power;

(8) To reduce labor relations controversies at their source, by unifying the interests of labor, management and stockholders;

(9) To take the initial steps to vest the dominant form of ownership of capital goods in our economy—the ownership of corporate stock—with the rights of private property, i.e., a claim of right to the proportion of the net corporate earnings represented by that stock; and

(10) To initiate reforms in the tax laws intended to enable U.S. consumers to become self-supporting, so that ultimately welfare, in any form, will not be necessary and social security can be reduced in scope to those who need it.

Our testimony will differ from that of other witnesses, however, because it is the product of a different economic analysis. Our proposals are based on the principles of two-factor economics, and specific recommendations are structured through the application of two-factor concepts.[1]

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[1] *Books*

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ESSAYS

"Cooperatives and the Economic Power to Consume," by Louis O. Kelso,, *The Cooperative Accountant* (published by the National Society of Accountants for Cooperatives), Winter 1964.

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"Statement of Louis O. Kelso and Norman G. Kurland Before the Committee on Finance, United States Senate, 91st Cong., 1st Sess., Oct. 2, 1969, on Federal Tax Policy to Create Full Employment by Broadening the Ownership of Productive Capital," Committee Print, pp. 589–705.

"Statement by Louis O. Kelso to the Committee on Ways and Means, House of Representatives, 93d Cong., 2d Sess., on Tax Proposals Affecting Private Pension Plans," Committee Print, May 16, 1972, pp. 647–720.

In view of this, a brief analysis of the concept of two-factor economics and of the financing techniques originally designed by Kelso Bangert & Co. Incorporated, and now in use by more than 100 U.S. corporations for the purposes of financing corporate growth while building capital ownership into corporate employees, and facilitating the financing of the purchase of stock representing the ownership of existing capital for corporate employees. In both these applications of Employee Stock Ownership Plan (ESOP) financing, the goals are normally achieved without taking anything from the pockets or paychecks of employees.

Those who are familiar with the concepts of two-factor economics and with its techniques for broadening the ownership of corporate enterprise and facilitating the financing of its economic growth need not review the remainder of the material under this title.

A BRIEF EXPLANATION OF TWO-FACTOR ECONOMICS AND OF ESOP FINANCING

The concept of "Two-Factor Economics" is new, basic, simple and straightforward. The reasoning runs as follows:

1. While it is true that people, doing their various tasks of participating in the economy in one way or another, are a basic source of productive input, they are not the *only* source of productive input.

2. Just as obviously, non-human things, like land, structures, and machines also provide input into the economy.

3. The sharp division of the input sources into two broad and exclusive categories is both necessary and adequate to understand the distributive dynamics of a private-property, free-market economy, because the ownership of *labor* power cannot be concentrated and the ownership of nonhuman things can easily be concentrated. It is, after all, an individual's *property* in an input factor that entitles him to receive what it produces.

4. Under the logic, the morality, and the double entry bookkeeping accounting of a market economy, it is productive input by each individual that is the basis for his receipt of income. Economic input is the basis for economic outtake or personal income.

5. Technological change, which is the phenomenon underlying the "industrial revolution," which began some 200 years ago, our own so-called automation revolution, and indeed of all the intermediate revolutions brought about by science and technology, alters, and is intended to alter, the input mix. It shifts the productive burden off labor or the human factor and onto capital or the nonhuman factor. Technological change does not operate directly upon humans at all; it cannot increase the economic productiveness of an individual worker, as such. The economic productiveness of human beings—what they can physically accomplish with their unaided muscles or minds—has not changed during the course of history, so long as the value of that productiveness is determined competitively under free operation of the law of supply and demand.

6. So far has this process of technological change gone in the U.S. economy that today most of the goods and services are produced by things and only a

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"Proposals to the Committee on Ways and Means of the U.S. House of Representatives," by Louis O. Kelso, Mar. 9, 1973.

"Memorandum to the Committee on Finance of the U.S. Senate in Support of S. 1370, a Bill to Facilitate the Expanded Ownership of Capital in the U.S. Economy, and on S. 1557, Employee Benefits Protection Bill, and on Private Retirement Systems in General," by Louis O. Kelso and Norman G. Kurland, June 1, 1973.

"Corporate Finance and Economic Reality," Testimony by Louis O. Kelso and Norman G. Kurland to the Financial Markets Subcommittee of the Senate Finance Committee, Sept. 24, 1973.

"Financing Economic Growth and Environmental Protection to Strengthen the Market Power of Consumers," testimony by Louis O. Kelso and Norman G. Kurland to the Committee on Environment of the Interior and Insular Affairs Committee of the U.S. House of Representatives, Jan. 31, 1974.

"A New Economic Policy to Meet the Needs of the American People and of the U.S. Economy," proposals to the President of the United States at the Economic Summit Meeting on Inflation convened in Washington, D.C., by Louis O. Kelso, Sept. 27–28, 1974.

"ESOP Financing as a Means of Making Governmental Tax Assistance to Business Correct the Maldistribution of the Ownership of Productive Capital—The Chief Cause of the Inadequacy of the U.S. Economy," testimony to the Senate Finance Committee on H.R. 2166, H.R. 462, by Louis O. Kelso and Norman G. Kurland, Mar. 10, 1975.

"Employee Stock Ownership Plan Financing and Other Financing Concepts Based on Two-Factor Economics," testimony of Louis O. Kelso and Norman G. Kurland in connection with hearings on tax policy and capital formation before the Financial Markets Subcommittee, Committee on Finance, U.S. Senate, 94th Cong., 2d Sess., Feb. 18–19, 1976.

minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence, while labor, in a free labor market, can at best normally produce only subsistence. The relative distribution of aggregate personal income in the U.S. economy between workers (roughly ¾ths), and the owners of capital (¼th) does not reflect this relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946) attempts to repeal the law of supply and demand as it applies to the value of labor: minimum wage laws, coercive fixing of wages, vast governmental make-work programs, governmental subsidies to industry and to other governmental entities, etc.

The costs of all such efforts enter into the cost of production either directly or indirectly and are thus inflationary. They become part of the costs of goods and services. These attempts to overvalue labor constitute the *monetization of welfare.*

7. The changing of the input mix in favor of capital would create no problems within the economy, even under competitive labor markets, if it happened that as technology enlarges the participation of capital in the production of goods and services and diminishes—relatively speaking—the participation of labor, workers simultaneously acquired the ownership of capital, offsetting their diminished productive power, or even better, increasing it, through their ownership of the other factor.

8. Unfortunately, the traditional techniques of finance do exactly the reverse of what is required: they assure that all newly-formed capital becomes automatically owned by those who previously owned all existing capital. Thus, the $100 billion-plus of new capital formation that comes into being in the economy of the U.S. each year becomes owned by a tiny capital-owning base: 5% of the consumer units at most. If averaged over the past 15 years, about 98% of new capital formation in the corporate sector (which produces over 85% of the goods and services of the private sector), is financed out of direct cash flow or borrowings repaid out of cash flow.

These overwhelmingly dominant methods of financing new capital formation have one characteristic in common: *not a single new stockholder is created in the process.* The minor percentage of new capital formation (about 2%) financed by sale of equity stock to the public does not alter this propensity. It is the top 5% of consumer units (in whom, as every qualitative study to date has shown, ownership of virtually all capital is lodged) that have the excess funds to buy newly-issued stock.

9. The logic of equity business finance is *to invest in productive capital that will pay for itself within a reasonably short space of time,* normally three to five years, which productive asset will then go on throwing off wealth indefinitely, its productive power being replenished through depreciation funds set aside out of gross income before net income is computed. Two-factor financing techniques, of which the most widely used today is the Employee Stock Ownership Plan or ESOP, make this logic available to employees.

10. ESOP financing, on the one hand, provides low cost capital, through the use of pre-corporate-tax funds, to finance corporate growth, and on the other hand, builds ownership into workers without diminishing their take-home pay or calling upon their small or nonexistent savings.

11. Under two-factor techniques, means are provided for financing unlimited growth, while building market power, economic security, and growing current second incomes from capital* into the masses of workers; *thus the market power of potential consumers rises in unison with the productive output of the economy.*

12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man to produce a viable income, becomes possible over a reasonable working lifetime; and the burden of public taxes imposed upon producers to support the non-productive and under-productive can ultimately be virtually eliminated. Fully productive households and individuals do not need to be subsidized.

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*Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the workers' pockets.

Specific Tax Reform Measures to Make the Use of ESOP Financing More Attractive to Corporations, Employees, and Labor Unions and to Accelerate the Production of Government Revenues Through the Increased Economic Activity Resulting From the ESOP-Stimulation of the Economy

TOWARDS AN ECONOMY THAT WORKS

In the several basic, yet simple amendatory legislative tax measures that we herein urge this Committee and the Congress to consider and to adopt, lies a program to accelerate the economy's growth, to reverse inflation, to create legitimate full employment within the economy for two or three decades, to permanently increase significantly the Federal Government's tax revenues (unless and until tax rates are further reduced), and in the course of accomplishing these objectives, to build the ownership of a large portion of the trillions of dollars of newly formed capital required to achieve ultimate general affluence (the only legitimate economic goal) into a broad and unconcentrated base of previously non-capital-owning consumers, rather than into the 5% of U.S. households that now own all of the productive capital in the U.S. economy.

Because these objectives sound impossibly Utopian—and indeed, are unrealizable through traditional approaches, or even imaginable under conventional economic preconceptions (or they long ago would have been achieved by free market economies)—we will introduce our proposals with this explanatory prologue.

Every economy in the world today—regardless of political orientation, economic organization or stage of industrial development—is in trouble. The secret of economic growth continues to elude not only the poor nations but the so-called rich nations. Technology makes it physically easy to produce wealth, and hence to eliminate toil and want. Yet there is some fatal flaw in our institutions that deflects technology from life-enhancing purposes to those often inimical to life and well-being. Man has now set foot on the moon, but for most men, women and children here on earth, the four horsemen of the Apocalypse—war, pestilence, famine and death—still ride. Man explores the seas and outer space to discover new benefits for mankind, but most people alive right now have yet to experience such simple old technological benefits as aspirin, plumbing or dependable sources of food and pure water. We in the United States, who have achieved the best general standard of living of any economy on Earth, suffer not only from widespread poverty among major segments of our population, but, although we are looked to for leadership in economic matters by the free world and by the "third world," provide no guiding model that can help them.

Everywhere the frustrations of poverty make life more precarious and violent for us all. Alienation spreads through groups once thought immune. Every system—totalitarian, welfare state, or democratic—is being attacked and repudiated by significant numbers of its own youth precisely because it fails to enable vast numbers of its citizens to *produce* and to *enjoy* the stream of desirable goods and services that clearly lie within the technological and resource potential of most countries and within the easy reach of an economy as richly endowed as ours.

All of these phenomena have political ramifications and symptoms, but their causes are basically economic. It is becoming increasingly evident that no line can be drawn between politics and economics, as economists have tried to do for the past thirty-five years. It is equally evident that economic questions cannot be separated from "values," as economists have also tried to do. Events have made it very clear that governments can no longer afford to entrust national economic policy to narrow interest groups, or to self-credential "experts" guided by unexamined myths or ideologies.

Large numbers of people in the United States, Great Britain, Australia, Canada, Sweden and other industrial countries are worried, with reason, about the future of individual freedom in societies where economic power is becoming increasingly concentrated in large-narrowly-owned, corporate monoliths from which the "human factor" is being systematically eliminated and the human scale increasingly overlooked.

Through internal financing of corporate expansion, management is eliminating potential stockholders. Through inadvertence or whatever, societies have lost

the functional essence of private property in the ownership of capital in their transition from an agricultural to an industrial stage of development. In particular, the owner of shares in business corporations have no *right* to their share of the income yielded by the corporation, as a coowner of land was entitled to his share of the profits produced by land. Stockholders have been converted from owners of productive private property into mere gamblers in the securities-speculation game. Through automation and refined organizational practices, the modern corporation systematically eliminates its employee constituents, its only other human constituents.

As a counterforce to concentrated economic power in corporations owned by only a handful of the total population, the propertyless, and hence, powerless, citizen has turned to government for protection, welfare and, increasingly, the income and jobs that the private sector fails to provide.

But this development has demonstrated once again the old political truth that power is linked to property. In a society where dominant political and economic power are combined in the hands of a monolithic government, controlled by a bureaucratic elite, the future of individual freedom is dim.

People in countries constitutionally committed to the protection of civil liberties are greatly worried about expanding governmental control of communications and information symptomized by such developments as "news management," electronic surveillance, and the storage of life-records of private citizens in centralized computer data-banks. Even more ominous is the growing financial dependence of both business and private citizens on government. Individuals, families, business corporations (even the biggest), and entire geographical regions, owe their livelihood directly or indirectly to government. Out of government-financed make-work, open and hidden—literally the monetization of welfare—erupts the double-digit inflation that is destroying the western industrialized economies like galloping cancer. Every society is becoming polarized as those dependent on tax-supported welfare and synthesized jobs confront, ever more angrily and desperately, those from whom government squeezes the tax funds.

History has amply documented the fact that individual liberties and a democratic form of government cannot endure unless the majority of citizens have a degree of economic independence. When the have-nots vastly outnumber the haves, democracy's days are numbered.

The absolute relationship between property and freedom has been the keystone of western political thought since Aristotle. Careful students of human affairs in every generation have confirmed this truth.

"In the main, it will be found that a power over a man's support is a power over his will."—Alexander Hamilton.

"The moment the idea is submitted into society that property is not as sacred as the laws of God, and that there is not a force of law and public justice to protect it, anarchy and tyranny commence . . . Harrington has shown that power always follows property. This I believe to be as infallible as a maxim in politics, as that action and reaction are equal in mechanics."—John Adams.

"Private property was the original source of freedom. It is still its main bulwark. Recent experience confirms this truth. Where men have yielded without serious resistance to the tyranny of new dictators, it is because they lacked property. They dared not resist because resistance meant destitution."—Walter Lippmann.

". . . if you believe in democracy, make arrangements to distribute property as widely as possible."—Aldous Huxley.

"Civil liberties must have a basis in property, or bills of rights will not preserve them."—Charles A. Reich, Professor of Law, Yale University.

"The rationale for private property is as valid today as it was two centuries ago. The man without property is powerless and defenseless . . . Independence of mind, freedom of action, can only result from possessing a source of income which is securely one's own. This is why Jefferson called for an America in which everyone would be a property owner. It is idle to call on propertyless men to be heroes or martyrs. One in ten thousand will answer such a call . . . Madison was also concerned about the interest (in politics) of those without property; but the propertyless, in reality, only become an interest when they organize to socialize private property."—Andrew Hacker.

"It is also true that the less possible it becomes for a man to acquire a new fortune, the more must the existing fortunes appear as privileges for which there is no justification. Policy is then certain to aim at taking these fortunes out of private hands, either by the slow process of heavy taxation of inheritance or by the quicker one of outright confiscation. A system based on private

property and control of the means of production presupposes that such property and control can be acquired by any successful man. If this is made impossible, even the men who otherwise would have been the most eminent capitalists of the new generation are bound to become the enemies of the established rich."—F. A. Hayek, The Constitution of Liberty.

The assumption underlying the often heard statement that "human rights are more important that property rights" is the strongest possible argument for broad private property ownership. In the world of practical affairs, no human rights can long be protected if the human right to own defendable private property in the means of production is ineffective, impaired or destroyed.

The alienation which is unravelling the social fabric of industrial societies everywhere, regardless of political persuasion or stage of economic development, is primarily economic in origin.

For millions of years, human labor was the principle factor of production, and free men were accustomed to own their labor power as their private property. Every man not an invalid knew that he was an economic producer; that he possessed in his own mind and body the power to produce the goods and services (or their income equivalent) that would provide for him and his dependents. Productive power was his as a free gift of nature. He knew that he was needed, and that knowledge gave him both dignity and self-assurance.

Industrial man has lost that primordial security. For while capital instruments are indeed "extensions of man," as Marshall McLuhan has said, in the practical economic sense they are extensions only of the men who own them or a share in such ownership, and who, as a consequence of ownership, are entitled to receive their share of the wealth their "extensions" produce. In a world where capital instruments are owned by a few, and unobtainable for the many, technology enhances the productive power of the few owners. But with pinnacle capital ownership, the great majority of men are robbed of their productive power by technological advance. They are deprived of their economic virility.

Society does not yet recognize the right of every man to be adequately productive in the way in which wealth is actually produced; through the ownership of his labor power, the ownership of productive capital, or both. Society does not yet recognize its obligation, by deliberate social policy, to enable every man legitimately to acquire private ownership of viable holdings of productive capital—thereby restoring, and indeed enhancing the productive power he has lost, or stands to lose, as technology shifts more and more of the burden of production from men to things.

Both the logic and morality of a free market, private enterprise economy are built on double-entry bookkeeping. Production and the distribution of purchasing power are not isolated phenomena. They are opposite sides of the same equation. The costs of production, on one side of the ledger, are, on the other side, purchasing power allotments to those who participate in production. Private property is the conduit or pipeline that returns to each participant in production the income value of his contribution.

The moral dimension of this process is the so-called Puritan Ethic, which, in a one-factor world, enjoins the individual to toil. Far from being exclusive to Puritans, however, the work ethic is universal. It is simply the concept of economic justice practically applied in the everyday process of producing wealth.

In a modern industrial economy, where a large proportion of the productive input into the economy is made through the non-human factor of production rather than through the human factor, mental or physical toil is, with rare exceptions, not adequate for legitimating the claim of most men to an affluent income. And because the Puritan Ethic is interpreted as the obligation to toil, it is under heavy attack today. Advocates of the "income-by-right" school and the "guaranteed employment" school declare that private property is obsolete in a world where capital instruments, not human labor, produce the preponderance of goods and services.

But in a world where poverty still claims the majority of human beings born, it is still vital to motivate men and women to do their best to produce the goods and services whose physical production and consumption is the only cure for physical deprivation. Before goods and services can be consumed, they must be produced. Therefore, the work ethic is still a value which society needs to cultivate. The work ethic is actually a production ethic. It is inspired by a hatred of economic dependence and a love of justice that seem to be a part of man's better nature. The solution, it would seem, is not to abolish private property rights in productive capital, as country after country is doing today by adopting reactionary socialism, but to make ownership of income-producing property in a rapidly expanding economy legitimately available to every individual and family,

so that everyone may be enabled to produce wealth, as a condition to receiving, as a right—a property right—the purchasing power arising from his productive contribution.

The problem confronting every economy in an industrial age, then, is: how, legitimately and consistently with the principles of private property, to put purchasing power into the hands of the economy's potential consumers, those whose unsatisfied physical needs and wants constitute the mass market which it is the purpose of mass production to satisfy, in such a way that both workers and capital owners, as individuals and as interest groups, are motivated to produce at a high level of efficiency, and to assure that the purchasing power arising from production is channeled back into consumption as fully as possible, so that purchasing power and production are maintained in equilibrium. No market economy has yet achieved this equilibrium, and, indeed, had Kelso Bangert & Co. Incorporated no new insight into the causes and solution of this problem, there would be no point in proposing tax reform measures to the Congress, as we do herein. The problem is old; it is older than Keynes, older than Marx, older than Adam Smith. Its solution depends on a master hypothesis radically different from any that has governed economics up to now.

Fortunately, in two-factor economics, or systems economics, as this new discipline is sometimes called, we have a new master hypothesis which promises to open up new, unsuspected opportunities and possibilities for understanding the economic world, for predicting the consequences of technological change, and for structuring institutions capable of harnessing technology to work for the individual well-being and freedom of every consumer within an economy.

The keystone proposition of two-factor economics is simple but momentous:

Wealth is produced by things as well as people, and the function of technology is to shift the burden of production from the human factor, labor, to the nonhuman factor, capital instruments, which man has invented or uses to harness the forces of nature.

If this proposition is true, many things which our age believes to be true are false. Much of what he world's leaders are doing and saying today in the area of economic goals and policy is illogical and self-defeating.

For example, if capital instruments produce an increasingly greater proportion of the wealth of an industrial economy, instead of "creating jobs," we should be creating new owners of capital. Instead of trying to fight poverty through "full employment," the goal should be to create general affluence through maximum production and maximum participation in production—not merely through jobs but through capital ownership. Instead of planning for perpetual economic toil, we should be planning for eventual leisure, for the time will eventually come, after a vast expansion of the productive capital plant of even the so-called highly developed economies, when only a fraction of those eligible for employment will be needed in the labor force of any advanced industrial economy.

WHAT ERROR IS RESPONSIBLE FOR OUR UNEMPLOYMENT, INFLATION, STAGNATED ECONOMIC GROWTH, AND INCOME DISTRIBUTION MISMATCH?

Present U.S. economic policy calls for solving the income distribution problems for all consumers through full employment, and to the extent that is not achievable, through welfare. At the same time, science, engineering, and management in business, industry and agriculture, strive ceaselessly to eliminate employment to minimize costs. Inflation flows relentlessly and unendingly from attempts of the Federal government to reconcile these unreconcilables, all of which take the form—recognizable or not—of the monetization of welfare. Money representing welfare is inflation in its essence.

TAX REFORMS URGENTLY NEEDED TO PREVENT CONTINUED AND PROGRESSIVE COLLAPSE OF THE U.S. ECONOMY AND TO REFORM IT SO THAT IT WILL FUNCTION WELL FOR ALL CONSUMERS

AMENDMENT OF THE NATIONAL ECONOMIC POLICY TO CHANGE IT FROM A ONE-FACTOR TO A TWO-FACTOR ECONOMIC POLICY

The idea of a defined national economic policy, the idea of the Joint Economic Committee, and the idea of the Council of Economic Advisors to the President, are all laudable and sound ideas. It is time, however, to expand the national economic policy into one that is consistent with the theory of universal capitalism. It is time to recognize and comprehend both factors of production in

national economic planning, in guiding private enterprise and in formulating governmental actions affecting the economy.

Broadening the Ownership of New Capital

Wealth in the United States is concentrated in the hands of a relatively small fraction of the population. Unfortunately, the data on wealth are sparse. The last comprehensive attempt by the Federal Government to measure its characteristics and distribution was made by the Federal Reserve Board in 1962. It was estimated that more than three-quarters of the country's total wealth was owned by less than one-fifth of the people, while more than one-quarter was owned by just the top 0.5 percent. The Federal Government should remedy the lack of up-to-date information on personal wealth through periodic surveys and comprehensive reports on this subject.

The distribution of wealth reflects in large part the pattern of ownership of non-residential capital with corporate shares being one of its principal forms. This category of wealth is much more concentrated than total wealth, with the top percentile of the personal income distribution owning 51% of the market value of individualy owned corporate stock and receiving 47% of the dividends. Meanwhile, the new capital assets generated by businesses, which in recent years have averaged well over $100 billion annually, redound largely to the benefit of these persons who already have great wealth.

The number of shareholders, moreover, declined by some 18 percent from 1970 to 1975, and data suggest that young people today are not purchasing stocks in significant volume. Balancing this declining role of the individual investor has been the rise of financial institutions, which since 1950 have more than trebled their share of the market value of stock holdings.

To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate incomes to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. The spirit of this goal and what it purports to accomplish was endorsed by many of the witnesses at our regional hearings.

Without getting into specifics, the types of programs which could be established to help meet this goal will be outlined. Such alternative methods of broadening capital ownership are under study by the Committee.

In the individual firm, employee ownership can be encouraged directly through tax incentives to the employees to purchase stock or to firms to place newly issued stock into the hands of their employees. The latter approach, known as Employee Stock Ownership Plans (ESOPs), was examined in recent hearings by the Committee.

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Whatever the means used, a basic objective should be to distribute newly created capital broadly among the population. Such a policy would redress a major imbalance in our society and has the potential for strengthening future business growth.

To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. Congress also should request from the Administration a quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time.

A proposed text for the amendment of the Employment Act of 1946 was included as an Appendix in Two-Factor Theory: The Economics of Reality, written by Patricia Hetter and Louis O. Kelso and published by Random House (paperback by Vintage Books) in 1967.

ADDITIONAL LEGISLATIVE "FINE-TUNING" IS NEEDED IF WE ARE TO BROADEN THE CAPITAL OWNERSHIP BASE WITH SUFFICIENT RAPIDITY TO AVOID ECONOMIC COLLAPSE

Let it be remembered that profit sharing and private conventional pension systems have been encouraged by legislation in the American economy for some fifty years, but still, 5% of the consumer units own all of the capital. It is quite obvious that much more effective measures, and much more effective leadership in supporting those measures, is necessary if we are to pull back from the brink of the greatest economic collapse in history.

Only if the U.S. economy can speedily broaden its proprietary base so that significant holdings of productive capital by millions upon millions of consumers

will begin to naturally yield second incomes to those who have nothing to sell in the market place except their labor power can the U.S. economy successfully turn around its downward spiral, reverse inflation, generate sufficient legitimate consumer demand to create full employment, and attain a sufficiently rapid growth rate to begin to produce adequate incomes for the majority of its consumers. The rate at which ESOPs are being adopted by corporations is insignificant compared to the rate that is necessary to cure the U.S. economy of its malaise within the time remaining for it to do so. Every reasonable congressional policy determination to stimulate the building of ownership into employees, public utility consumers, and eventually into all consumers is needed if we are to achieve this result with sufficient speed.

It is of enormous significance that the giant American corporations that have adopted ESOPs have done so only to the extent of the additional 1% of investment credit that thus becomes available to them under the existing law. That same exising law accords an annual gift of the ownership of $8.4 billion of newly formed capital annually to the already rich—the 5% of whom all statistical studies show to own 100% of the productive capital within the economy! Thus it is perfectly clear that as the law stands, the message Congress is giving to the corporate sector is to build the ownership incremental capital—newly formed capital—into the already rich at a rate ten times as fast as that (the 1% investment tax credit ESOP) which would build capital ownership into the presently capital-less employees!

ESOP FINANCING IS A POWERFUL MEANS OF STIMULATING CORPORATE GROWTH AND THUS IS A MEANS OF GENERATING ADDED FEDERAL REVENUES: THE BRIEF REVENUE LOSS RESULTING FROM TAX DEDUCTIBILITY IS SHORTLY OFFSET AND SOON RETURNS TO THE TREASURY MANY TIMES OVER THE REVENUE LOSS THROUGH THE INCREASED PRODUCTIVENESS OF THE ECONOMY

RECOMMENDED CHANGES TO REDUCE THE WEALTH-CONCENTRATING EFFECT OF THE INVESTMENT TAX PROVISIONS OF THE PRESENT LAW AND TO CAUSE FULL USE OF THE INVESTMENT CREDIT TO BROADEN CAPITAL OWNERSHIP

According to press reports, the House Ways and Means Committee recently approved a proposed amendment to the Internal Revenue Code provisions relating to investment credit (Internal Revenue Code Sections 46, 47, and 48; Sections 301, 302, and 304 of the Tax Reduction Act of 1975) to provide that the now effective 10% investment credit provision would be continued through 1980, but omitting the optional 1% available to corporations which capitalize an amount equal to the added 1% and deposit the stock thus issued to an employee stock ownership plan (ESOP) trust, or which contribute an equivalent amount of cash to such a trust for the purchase of outstanding stock.

The following proposal is respectfully submitted to the Senate Finance Committee for amendment to the investment credit proposal of the House when the Bill reaches the Senate.

At the outset, it should be recognized that an investment credit is—in practical effect—a gift by taxpayers to corporations that invest in certain types of capital expansion, for the purpose of encouraging that economic growth upon which the strength of our economy so heavily depends. But it is also true that virtually all of the equity ownership of U.S. corporations lies within the top 5% of wealth-holding consumer units. Thus, as it stands, the House-proposed revision of the investment credit bill would seem to promote one important social purpose, namely accelerating new capital formation, but to more than offset this benefit by building 100% of the ownership of the newly formed capital thus encouraged into the already rich and allocating NONE of that ownership to the capital-less labor force upon which our economic strength, as well as the market power of our economy, also heavily depend. The following proposal is designed to ameliorate this tendency of the House bill to make the rich richer and to keep the poor poor.

RECOMMENDED CHANGES IN THE HOUSE PROVISION

1. The percentage of investment credit permissible under the provisions of the Tax Reduction Act of 1975—11% of eligible investment—should be retained.

2. The period of the law should be increased from four years, as now proposed by the Ways and Means Committee, to ten years, or better still, made permanent. The purpose of this is to enable major corporations to plan large expenditures that, in many cases, require ten years to plan and construct.

3. Six percent of the 11% investment credit would be available only on an optional basis, and only if the corporation issues new common equity equal in value to the amount of the credit optionally taken, and transfers that stock to its ESOP. The full 6% need not be taken, and any lesser portion thereof could be taken, provided the full value of the portion of the optional 6% taken as a credit be thus capitalized and issued to the taxpayers-corporation's ESOP. No such condition would be applicable to the first 5% of eligible investment credit.

4. For purposes of valuing the newly issued capital stock transferred to an ESOP trust, the stock would be valued at fair market value (as contemplated by the Tax Reduction Act of 1975) or, if higher, at book value at the time the credit is claimed. This provision would prevent dilution of the stock holdings of the existing shareholders during times of recession when the market price of the taxpaying corporation's stock may be lower than the book value. On the other hand, it does not affect the government revenue, but only the number of shares transferred to employees to represent their participation in the government gift to corporations to stimulate economic growth. Since this would fully eliminate the corporate stock dilution problem, the usability of a cash contribution to an ESOP to purchase outstanding stock as permitted now by the Tax Reduction Act of 1975, would be eliminated. The focus is on promoting new capital formation and upon expediting the improvement in the capital-debt ratio of corporations, particularly public utilities.

5. The provision of the present law, under the Tax Reduction Act of 1975, which requires a "pass-through" of the voting on the stock transferred to an ESOP to comply with the investment tax law, would be eliminated. The object of this proposal is to build capital ownership into employees, but this does not require imposing any barriers to management's decision to elect the additional investment credit that might arise out of a mandatory requirement for the "pass-through" of the stock vote. The great majority of ESOP plans now in existence do not pass through the vote but rather leave it in the hands of the trust community until the stock is distributed to the employees in accordance with the provisions of the plan.

6. The minimum investment credit to which the provision with respect to capitalization and transfer of stock to an ESOP for the employees of the taxpayer would apply would be $100,000. Any corporation electing to take an investment tax credit of not more than $100,000 would be entitled to the full 11% credit free of the requirement of establishing an ESOP and capitalizing that part of the credit in excess of 5% of the eligible investment.

7. Dividends payable by a taxpayer corporation into an ESOP would be made deductible from the corporate income tax, provided the dividends so paid are in turn paid currently by the ESOP trust directly to the employees into whose accounts the stock has been allocated. This provision should apply to all stock of the taxpayer corporation held by its ESOP, whether acquired as the result of the optional investment tax credit or otherwise. Such payments should be made within ninety days from the end of the fiscal year in which the dividend is paid, *Provided, however*, That if the stock was acquired by the ESOP trust through loan financing, such dividends may be applied to the repayment of the loan used to acquire such shares. This would merely relieve the corporation of the income tax on the dividends paid to employee-stockholders, who would in turn pay ordinary income taxes on their augmented incomes; this would be the most powerful means of convincing employees that they are being made partners with present stockholders and with management in the ownership of U.S. enterprise.

8. As under the Tax Reduction Act of 1975, there would be immediate vesting of the investment credit stock in the ESOP trust, but it could not be physically distributed to employees until after seven years. The voting of corporate stock held by the ESOP trust and other features of the ESOP would conform to the applicable provisions of the Employee Retirement Income Security Act of 1974 and of the Internal Revenue Code.

THE PRESENT AND HOUSE-PROPOSED INVESTMENT TAX CREDIT PROVISIONS ANALYZED IN THE LIGHT OF TWO-FACTOR THEORY

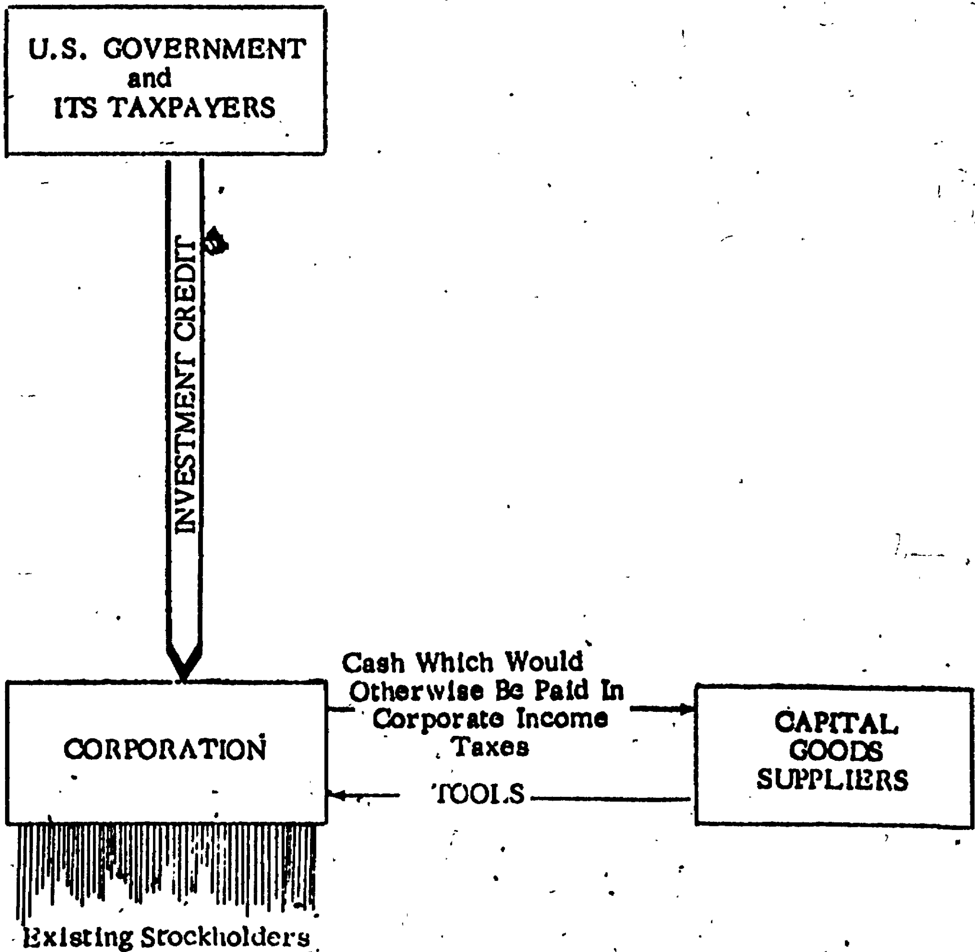
Without an analysis of the investment tax credit in the light of two-factor economics, the ultimate economic effect of the investment tax credit under the now-existing law can be observed. Corporations can become so accustomed to the investment tax credit and its important advantages to them and their stockholders, that sight may be lost of the fact that it is a gift, coerced by the tax law,

from all taxpayers to the tiny 5% of consumer units who own almost all of the capital in the U.S. economy!

The following diagram illustrates the point:

DIAGRAM I

The Investment Credit Does Help Stimulate New Capital Formation,
But Concentrates Ownership of That Newly Formed Capital
In Existing Stockholders.
It Is a Government Subsidy To Make The Rich Still Richer.



NOTE: Not a single new stockholder is created by this process. Ownership of the total newly-formed capital generated by the tax subsidy is acquired by the existing stockholders.

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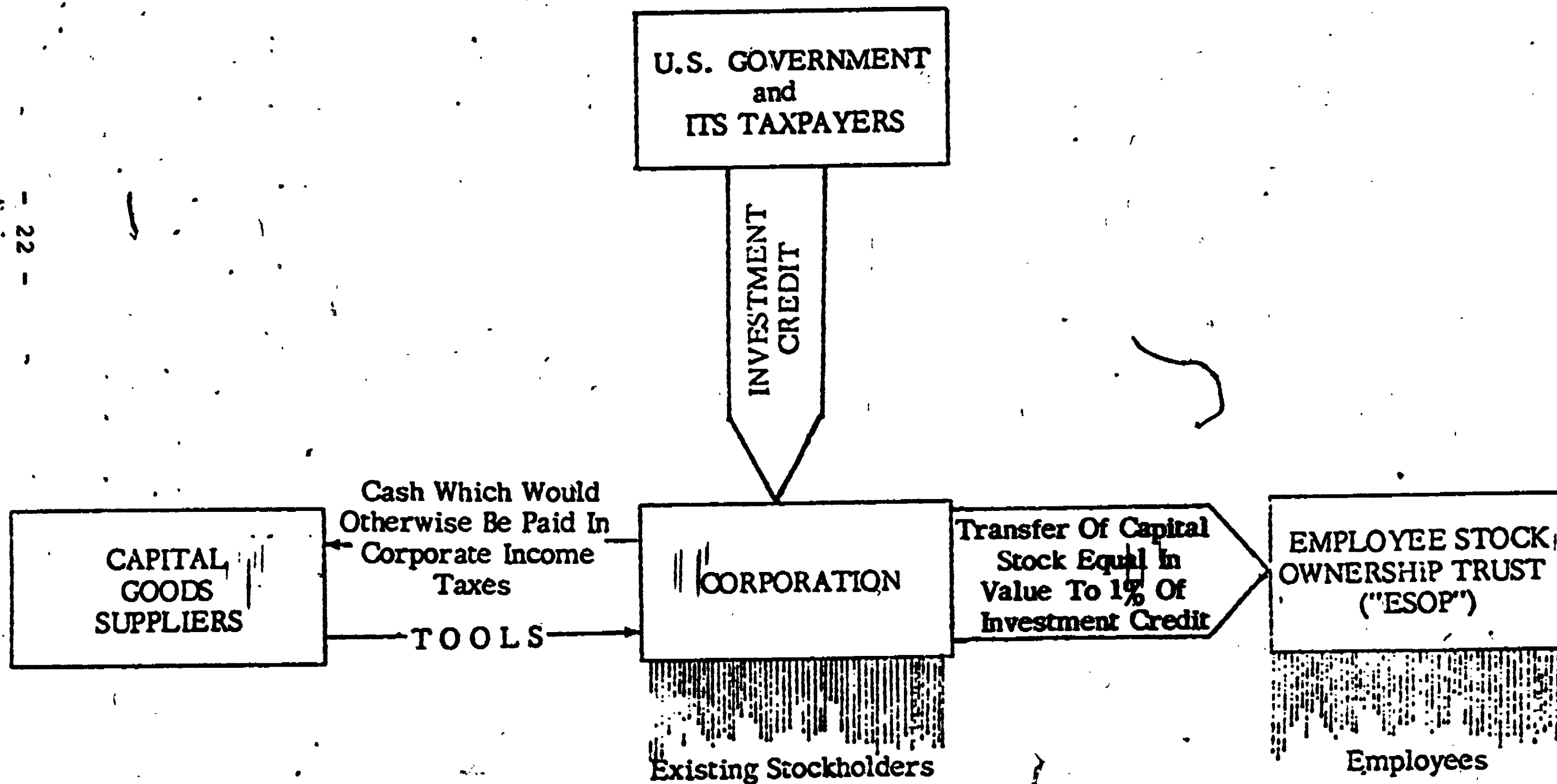
Now let's see what a diagram of the ITC-ESOP, if elected by a corporation, thus requiring it to capitalize the amount of the operational 1% and transfer the stock thus issued to an ESOP, would look like:

DIAGRAM II

An Amendment To H.R. 2166 That Would Link The Use Of At Least Large Investment Credits To Corporate Capitalization Of 1% Of The Investment Credit And The Transfer Of The Resulting Stock To An Employee Stock Ownership Trust (ESOP) For The Benefit Of Employees In Proportion To Their Existing Stockholders Ownership Of The Newly-Formed Capital Generated By The Increased Investment Credit.



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The following comments are relevant to a comparison of the optional ITC-ESOP portion of the investment tax credit with the conventional tax credit, as illustrated by the two diagrams above:

(a) It should be noted that both in the cases of the conventional investment tax credit and the optional ITC-ESOP, there is involved a *gift* by all the taxpayers, required by the tax law, in pursuance of a policy of encouraging the financing of new capital formation (a policy with which we heartily agree) to the corporation to help it pay (to the extent of the investment tax credit) for the newly formed capital put in operation during the tax year.

(b) In the case of the conventional investment tax credit, the gift is from all taxpayers to the 5% of consumer units who own, as shown by all qualitative studies of the U.S. economy since 1938, all the personally-owned corporate stock. These 5% of consumer units therefore own, so far as any individuals do, all of the corporations in the U.S. economy. It is a gift, for the most part made involuntarily, by the poor to the rich.

(c) If public policy took full cognizance of the fact that the concentration of the ownership of productive capital in the top 5% of consumer units is the chief evil in the U.S. economy, the investment tax credit would be permitted to accrue, to the extent of 5% of the actual credit taken, to the existing shareholders—because they represent 5% of the total consumer units in the economy—and 95% of the investment tax credit taken would be capitalized and put in an ESOP for the employees.

Unquestionably, the receipt of any shares by employees through an ESOP would be a great advance over the present situation under which the entire taxpayer gift—amounting for the economy as a whole to approximately $8.4 billion—redounds solely and exclusively to the benefit of the tiny pinnacle class of consumer units, 5% in all, who own all of the capital stock of U.S. corporations today. Obviously, the problem here is one of degree.

The United States economy is in a perilous condition. A major, though at present unmeasured, portion of its economy is withheld from bankruptcy by governmental subsidies of a thousand and one kinds. The national debt grows apace and inflation ravages our currency. As goods and services become technically easier to produce, income becomes harder to get, and the great majority of U.S. families and consumers struggle vainly for what is—relatively speaking—a meager living.[1]

Our largest cities, several of our largest states, our largest railroads, many of our major banks, many of our largest manufacturing concerns, and thousands upon thousands of businesses in general are bankrupt or are teetering on the verge of bankruptcy. To believe that this perilous situation is going to correct itself is simply to be blind to the fact that it is directly traceable to the structural flaw in our economy: most of our goods and services are produced by capital and only 5% of our consumer units own any capital whatsoever. Redistribution by government and by governmentally supported wage coercion (all of which go into inflationary costs) has reached the point of provoking a taxpayers' general strike.

Nothing short of the most strenuous effort on the part of government to facilitate the building of capital ownership into the noncapital-owning masses of consumers will pull us back from the brink of total disaster.

We take false comfort from the fact that our example is followed by all of the other market economies of the world, and that in following our example they are getting into trouble as deep or even deeper than ours. Thus, relatively, we do not look so bad, although we all are headed for certain economic collapse unless we begin to make sense of our economies and, indeed, convert them into economic systems, as we are urging.

But the present 1% voluntary additional investment credit available to corporations that capitalize that 1% and transfer the stock to an ESOP trust involves a still more frightening problem. First, we believe, and have repeatedly stated, that the strength of the United States is dependent upon its technology, its great accumulations of capital instruments, and its ability to bring into existence enormously greater productive power in the form of new capital formation. We therefore applaud governmental policy that encourages such new capital formation,

[1] The affluence of an economy can only be honestly measured by comparing what it is technically capable of producing in goods and services with what its people expect and desire it to produce. By that standard, U.S. citizens are poorer than the people of India!

particularly under the present circumstances of our economy, which is too ill-designed to finance economic growth.

But if, as we are confident is the case, there is a time bomb ticking away in the U.S. economy because most of our goods and services are produced by capital, and only 5% of the consumer units own any capital, then it is nothing short of astonishing that Congress—particularly those of its members who style themselves as liberals—should command a gift to be made by all taxpayers to the already rich, to the extent of about $8½ billion a year! For the investment credit is, in fact, a gift from the taxpayers as a whole, to the top 5% of wealth holders who own the corporations that take the investment credit.

We have heard of a thing called "practical politics", and understand that under "practical politics" Congress does not make sudden major changes, no matter how rational, nor indeed, how imperative the need may be. Consequently, perhaps the most we can hope for is that 50% or so of the investment credit will be required to be capitalized and transferred to the workers. We still think it is important that when we do this, we understand what we are doing: we are making a gift of about $4¼ billion to the already excessively rich, and using $4¼ billion of the investment credit to build self-sufficiency into the financially underpowered American workers.

In a later section of this paper, we will outline some of the additional steps that Congress could, and, we earnestly hope, will take in order to avoid the collapse of the American economy—steps that would facilitate both the acceleration of the economy's growth rate and the broadening of its capital ownership base.

SPECIFIC TAX REFORM RECOMMENDATIONS WHICH WE URGE THE SENATE FINANCE COMMITTEE TO ADOPT (WHETHER INITIATED BY SENATE BILL OR WHETHER INTRODUCED INTO THE HOUSE OF REPRESENTATIVES AND ULTIMATELY REFERRED TO THE SENATE FINANCE COMMITTEE)

H.R. 462, The "Accelerated Capital Formation Act of 1975"

Attached hereto as Appendix I is a copy of H.R. 462 and the explanatory Floor Statements made by Congressman William Frenzel, who introduced this bill into the House of Representatives on January 14, 1975, during the Ninety-Fourth Congress, 1st Session.

H.R. 462 contains several legislative "fine-tuning" steps that would greatly facilitate the use by corporations of capital ownership broadening ESOP financing. We have taken each of these provisions, with some modifications based upon our discussions of that bill with various members of Congress and Senators and with buisness executives, and have converted each provision into a separate proposed bill, copies of which are attached hereto respectively as Exhibits II to IX inclusive.

INASMUCH AS TWO HUNDRED OR MORE (NO ONE KNOWS THE EXACT NUMBER) U.S. CORPORATIONS HAVE ADOPTED ESOPS, WHY IS ANY "FINE-TUNING" OR FURTHER FACILITATING LEGISLATION NEEDED?

While it is true that a significant number of corporations have adopted ESOPs, including, according to published reports, some of the largest, such as Standard Oil Company of California, Atlantic Richfield Corporation, Mobil Oil Corporation, Hallmark Corporation, Gamble-Skogmo Corporation, and two hundred or so smaller corporations, it is certainly a proper question to ask: "Why, then, should further legislation be necessary?"

The answer is that the largest corporations have adopted ESOPs solely for the purpose of attaining the additional 1% investment tax credit which is available under present law to them only if they capitalize the amount of the additional 1% and place the stock thus issued in an ESOP for their employees. They have not adopted the use of ESOP financing for the tens of billions of dollars required to finance their annual growth! This gigantic stream of newly formed capital continues to be financed in ways that assure that it will become owned by the already rich, who have no functional need for additional capital, and that none of it will be channeled into building adequately large estates for their employees, in order to assure that they are economically self sufficient by the time they attain retirement age or before.

SPECIFIC LEGISLATIVE MODIFICATIONS THAT WOULD GREATLY ACCELERATE THE ADOPTION BY BUSINESS OF FINANCING TECHNIQUES THAT WILL BROADEN THE CAPITAL OWNERSHIP BASE OF THE ECONOMY

In H.R. 462, originally introduced by Congressman Bill Frenzel on January 14, 1975 and now the subject of a study by a task force appointed by Chairman Al Ullman of the House Ways and Means Committee, nine proposals were set forth. (The text of H.R. 462, together with Congressman Frenzel's excellent Floor Statement, as set forth in the Congressional record, is attached hereto as Appendix I.) With some slight modifications, resulting from our conferences with various senators, congressmen, and members of the staffs of the Senate Finance Committee, the House Ways and Means Committee, and the Joint Committee on Internal Revenue Taxation, we have prepared and attach as Appendices hereto separate proposed bills, each containing, in some cases with minor modifications resulting from study and comment, covering, in the aggregate, the proposals of the bill pending in the House Ways and Means Committee: the "Accelerated Capital Formation Act," H.R. 462, Appendix I hereto. These are respectively Appendices II to IX hereto, inclusive.

BECAUSE THE CORPORATE TAX DEDUCTIBILITY OF PAYMENTS INTO AN ESOP CAUSES ONLY A TEMPORARY DIMINUTION OF GOVERNMENT REVENUES, FOLLOWED BY A RESTORATION OF THOSE REVENUES AND A CONTINUOUS INCREASE THEREAFTER IN SUCH REVENUES, THE OVERALL EFFECT, WE BELIEVE, OF THESE MEASURES WOULD BE SPECIFICALLY REVENUE PRODUCING.

The analysis of the revenue effect of ESOP financing is set forth in pages 32 to 41 hereof. Were a major segment—say 25%—of U.S. corporations to adopt ESOP financing techniques for a major portion of their capital financing requirements during a single year, and if the revenue-reducing effect of such widescale adoption is not offset by reductions in unemployment compensation, welfare, food stamps, job subsidies, and other forms of government aid (as we firmly believe it would be), several years of governmental revenue reduction might result. It is of vital significance, however, that these deficits would be restored by the incremental tax revenues of government in six years or so, and that thereafter, incremental revenues from the increased capital formation added during the deficit years would continue to pour added revenues into the U.S. treasury.

The likelihood of any such rush into the use of ESOP financing techniques, irrespective of how attractive they may be made, is, in our opinion, virtually nil. Corporate finance is the most conservative facet of business activity, and business in general is notorious for its conservatism. Even though Congress should enact each of the measures proposed in our testimony, and combine those with other measures of its own initiation or proposed by others to accomplish the same objectives, the U.S. economy will indeed be fortunate if its ownership base is broadened with sufficient rapidity to prevent a collapse comparable to, and perhaps more severe than, that of the 1930's. Even if tax measures were adopted to give corporations tax credits for payments into ESOPs rather than tax deductions, the rate of change, in our opinion, would still not be as rapid as would be desirable.

REMOVING THE PRESENT STATUTORY LIMITATIONS ON PAYMENTS INTO AN ESOP TRUST (25 PERCENT OF COVERED PAYROLL LESS FORFEITURES) BY AN EMPLOYER, AND SUBSTITUTING A LIMITATION BASED UPON DEBT-SERVICING REQUIREMENTS OF THE ESOP TRUST

This bill, a draft of which is attached hereto as Appendix II, would remove the present statutory limitation of 25 percent of covered compensation as the maximum amount an employer can annually pay into a qualified ESOP when such payments are used to enable the plan to repay stock acquisition debt incurred in connection with meeting the employer's capital requirements. This places the sole limitation on financing payments on the enterprise's capacity to service the debt out of cash flow. This reform reduces the cost of capital growth and the cost of transfers in the ownership of corporate assets, while accelerating the rate at which employees as individuals and as a group can accumulate stock of

their employer and other income-yielding assets as a new and noninflationary form of employee benefit. Although treated as a tax deduction, this change would have impact similar to that of the investment tax credit in terms of encouraging capital spending, but without the effect of the investment tax credit of increasing the concentration of corporate ownership.

This also rechannels corporate profits that would otherwise have gone into the corporate income tax into productivity increases of the private sector, thus generating lower prices for consumers, expanded private payrolls, and a broadening base of taxable personal incomes and personal estates among productive workers. After a brief period of years. the revenue loss would be restored and the greater productive power of the added capital would continue indefinitely to increase income tax revenues of the Federal Government if the tax rates remain unchanged.

ALLOWING TAX DEDUCTIONS UNDER PERSONAL INCOME, ESTATE AND GIFT TAX PROVISIONS FOR CONTRIBUTIONS TO AN ESOP TRUST, SIMILAR TO CONTRIBUTIONS TO CHARITABLE FOUNDATIONS

A draft of a bill covering this provision is attached hereto as Appendix III. The bill would provide that a qualified employee stock ownership plan and trust shall have the tax characteristics of a charitable organization for purposes of personal income, estate, and gift taxes. This would encourage affluent taxpayers to make gifts to qualified trusts in order to reconnect the ownership of capital with a broader base of private individuals, namely productive employees some of whom would normally have contributed to the building of the donor's wealth. Allocations to participants of the trust would become an immediate source of taxable second incomes—to the extent dividends are passed through the trusts—and a retirement estate for the employee-beneficiaries and their heirs. On the other hand, Government would *gain, rather than lose* tax revenues since such contributions made to conventional charitable organizations are already exempt from taxation, and profits from donated income-producing property are accumulated tax-free within such organizations.

ALLOWING TAX DEDUCTIONS UNDER THE CORPORATE INCOME TAX FOR CORPORATE DIVIDENDS WHICH ARE DISTRIBUTED THROUGH THE ESOP TRUST AS SECOND INCOME TO EMPLOYEES, OR WHICH ARE APPLIED TO REPAY FUNDS BORROWED BY THE ESOP TRUST TO PURCHASE THEIR STOCK

A suggested bill setting forth this provision is attached hereto as Appendix IV. The bill would provide a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust. This provision also converts taxable corporate income into either taxable dividend incomes for employees to supplement their paychecks or to supplement their retirement and social security incomes, or causes a more rapid rate of accumulation by employees of individual capital estates for their retirement security. In short, this bill would rechannel funds that would be taken out of the tax base if put into tax exempt foundations back into the economy and the income, estate and gift tax base for Federal and state governments and the property tax base of state and local governments.

ALLOWING FOR A LIFETIME ACCUMULATION UNDER AN ESOP OF UP TO $500,000 FOR ANY INDIVIDUAL EMPLOYEE

A bill, referred to above, both setting forth this provision and eliminating the present limitations of 15% or 25% of covered payroll, is attached hereto as Appendix II. The bill would establish a cutoff on further contributions in behalf of any employee when the value of the assets that employee has acquired during his working lifetime through one or more ESOPs exceeds $500,000. Such a safeguard on excessive accumulations acquired through tax deductions would be especially important in highly capital-intensive industries and would help foster more widespread and equitable sharing of ownership among Americans generally.

ALLOWING FOR DISTRIBUTIONS FROM AN ESOP OF A DIVERSIFIED PORTFOLIO (INCLUDING EMPLOYER STOCK) AND ELIMINATING TAXATION ON THE ASSETS DISTRIBUTED TO THE EXTENT THAT THE INCOME-PRODUCING ASSETS ARE HELD BY THE RECIPIENT, OR, IF SOLD, THE PROCEEDS ARE PROMPTLY REINVESTED IN OTHER INCOME-PRODUCING INVESTMENTS

Proposed bills containing these provisions are attached hereto as Appendices V and VI. These bills would add to the options of ESOP participants when distributions are made when they retire, die, or are otherwise separated from service. Although profit sharing plans are permitted to make distributions in many forms, the Internal Revnue Service has ruled that distribution from an ESOP must be made exclusively in employer stock.

Although enabling employees to accumulate sizable holdings of employer stock has obvious motivational value, when an employee leaves the company and can no longer directly influence the yield on the company stock accumulated in his ESOP account, it is desirable to permit an exchange by the retiring or separating employee of his accumulated holding of employer stock for other income-yielding assets of an equivalent value. This could be a diversified portfolio of securities, an annuity, or whatever investment the employee prefers. This bill would provide ESOP's the same flexibility in making distributions that is now enjoyed by profit sharing plans.

The bill would also exempt lump sum distributions of income-yielding estates derived from an ESOP from any form of taxation, provided the assets are held to produce a taxable second income for the taxpayer or his beneficiaries. However, if the assets are converted into spendable income and not reinvested within 60 days, the uninvested proceeds will be taxed as ordinary income, instead of partially at the lower capital gains rate permitted under present law. It seems illogical, having taken years to build economic self-sufficiency, in the form of capital ownership, into an employee to take away a third or more of his productive holding at the very moment he needs it most. The government needs taxpaying retired people. The economy needs retirees who support themselves and produce good incomes to spend in the market place.

PROVIDING A PROCEDURE FOR ADVANCE IRS OPINION REGARDING ESOP FINANCING TRANSACTIONS—A "NO-ACTION" PROCEDURE SIMILAR TO THAT USED BY THE SEC AND THE FEDERAL TRADE COMMISSION FOR DECADES. THIS WOULD AVOID THE TAXPAYER AMBUSH THAT IS INHERENT IN PRESENT PROCEDURES

A proposed bill setting forth this provision is attached hereto as Appendix VII. The bill would enable affected parties to seek advance IRS opinions on valuations of stock or other assets acquired by an ESOP where the parties to a financing transaction which utilizes an ESOP would be subject to serious risks or penalties if the IRS, upon subsequent audit, disagreed with the valuations or other key features of the financing plan. This is similar to the "no action" procedures already instituted by the FTC and SEC.

AMENDING THE LAW TO RECOGNIZE THAT ESOP FINANCING IS NOT A FORM OF DEFERRED COMPENSATION, OR INDEED COMPENSATION AT ALL, AND THAT IT SHOULD BE EXEMPT FROM ANY EXECUTIVE ORDER, REGULATIONS, OR FUTURE ECONOMIC STABILIZATION LAWS AT THE FEDERAL OR STATE LEVELS

This provision is set forth in Section 4 of H.R. 462, Appendix I hereto. This provision of H.R. 462 would exempt payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the Federal or State levels. Instead, it would be treated as any other form of capital spending that would have a counterinflationary effect. It would offer labor a trade-off for wage increases if wage ceiling should ever be established.

PROPOSED AMENDMENT TO ERISA CLARIFYING FIDUCIARY DUTIES APPLICABLE TO ESOP TRANSACTIONS

A proposed bill attached hereto as Appendix VIII, would amend the Employee Retirement Income Security Act of 1974. This bill would eliminate any doubt,

which may exist under the present law, that an ESOP, in acquiring or holding qualifying employer securities, or incurring acquisition indebtedness for the purchase thereof, does satisfy the provisions of ERISA and that the same standards of prudence and fiduciary responsibility are applicable as those which must be observed by corporate management with respect to non-employee shareholders.

PROPOSED AMENDMENTS TO THE INTERNAL REVENUE CODE RELATING TO THE DEFINITION OF AN EMPLOYEE STOCK OWNERSHIP PLAN

A proposed bill to more precisely define an Employee Stock Ownership Plan, by amending the relevant Internal Revenue Code section, is attached hereto as Appendix IX. Not only would this bill clarify, once and for all, the purpose and nature of an Employee Stock Ownership Plan as a financing device, on the one hand, and as an instrument for building ownership of qualifying employer securities into employees, on the other, but it also would give the Secretary of the Treasury, or his delegate, the power to prescribe regulations further defining ESOPs.

The bill would further amend the Internal Revenue Code to clarify the fact that either common stock or preferred stock convertible into common at a reasonable conversion ratio may be acquired by an ESOP. This gives greater flexibility to the ESOP mutually solving financing plans and employee ownership requirements.

PROJECTED EFFECTS OF ESOP FINANCING ON FEDERAL TAX REVENUES OVER A TWENTY-YEAR PERIOD—SUMMARY OF FINDINGS

Concern has naturally been expressed as to the effect that widespread adoption of ESOP financing programs by U.S. corporations would have on Federal corporate income tax revenues. Because present tax law allows payments to the ESOP by the corporation to be treated as a tax-deductible expense, there is some fear that widespread adoption of this type of financing would seriously reduce tax revenues and would impair government's ability to achieve a balanced budget while carrying on other necessary government activities. To analyze the effect of ESOP financing on Federal tax revenues, twenty-year forecasts of income and tax payments were made for a variety of financing alternatives available to a sample company, assumed to be a micro representative of all U.S. corporations. The analysis yielded the following results.

(1) Total tax revenues for the projected twenty-year period are greater under ESOP financing than would be realized under conventional debt financing or internal cash flow financing, the two techniques that have accounted for about 98 percent of financing of new capital formation averaged over the past fifteen years. This comparison omits straight equity financing both because it has been of almost negligible importance and because we are convinced that it will, except for brief intervals, continue to be negligible.

(2) Tax revenues in the first three years after the ESOP financing transaction occurs are lower than with the alternative types of financing but this short-term loss is recouped within five years after the transaction. Thereafter, tax revenues realized from ESOP financing are greater than the other types of financing considered.

(3) Under ESOP financing, real corporate income growth is greater than would be possible under debt financing or internal cash flow financing. This leads to a stimulated economy and, over the long term, higher income tax revenues.

(4) Under ESOP financing, the U.S. Government has, in effect, made an investment in U.S. business by allowing a short-term tax incentive. The analysis results have shown that this investment has paid for itself within five years and, thereafter, continues to pay for itself again and again.

(5) Treatment of the payment by the corporation to the ESOP as a tax credit rather than as a tax-deductible expense, as is now required under existing law, would stimulate the highest rate of corporate income growth and result in even more income tax revenues over the twenty-year period than is possible under present law.

(6) Future tax legislation should offer additional tax incentives for corporations that use ESOP financing techniques since this will benefit the corporations, and their employees, as well as the U.S. Government and U.S. taxpayers.

Methodology

To determine the effects of various financing methods on federal tax revenues, the income stream of a fictitious company, hereafter referred to as ABC Company, was projected over a twenty-year period. It can be assumed that ABC Company is a micro representative of U.S. corporations as an aggregate and that its tax revenue streams are an accurate representation of those that would occur on a macro basis. The Kelso Bangert & Co. Forecasting Model was used to develop the twenty-year projections. The model simulates, as accurately as possible, the cash flow patterns of the Company and takes into account deferred payments, etc. For this analysis, the output consisted of twenty pages of computer print-out, which is available to the Committee's staff for inspection, but which, for its sheer bulk, has not been attached to this written submission.

Assumptions

(1) ABC Company has operating profit (before interest, pension costs, and taxes) of $1.8 million and stockholders' equity of $10 million.

(2) The Company's effective tax rate is 50%; it pays no dividends nor does it offer a pension plan or other deferred compensation program. ABC Company has no debt, is earning 8% after corporate income taxes on equity and can, therefore, maintain an 8% annual growth rate through internal cash flow financing.

(3) The Company is considering construction of a new plant which it believes will provide an after-tax return on investment of 10% (20% pre-tax). The cost will be $1 million. The Company is also under pressure from its employees to adopt some plan that will provide retirement economic security for them. Several financing alternatives are being considered. To determine the optimum financing strategy, ABC Company has decided to analyze the following cases:

(*a*) No Financing/No Pension Plan
(*b*) No Financing/Pension Plan
(*c*) Debt Financing/Pension Plan
(*d*) ESOP Financing/With Its Attendant Repayment Through The ESOP
(*e*) ESOP Financing/Tax Credit (Assuming Federal Tax Law Permitted ESOP Payments To Be Treated as Tax Credits Rather Than Deductions)

(a) *No Financing/No Pension Plan*—In this case, ABC would not construct a plant nor implement a pension plan. The Company's future operations would be financed only through internal cash flow which would support an annual earnings growth rate of 8%.

(b) *No Financing/Pension Plan*—In this case, ABC would not construct the new plant but would implement a pension plan. The level of contributions to the plan would be such that the plan's assets would total $4.1 million by 1995. Contributions would begin in 1977.

(c) *Debt Financing/Pension Plan*—In this case, the Company would incur a $1 million loan to construct the new plant. The loan would bear interest at 10% and would be retired over five years with equal payments of interest plus principal. In addition, ABC would adopt a pension plan and make the contributions necessary to accumulate plan assets of $4.1 million by 1995.

(d) *ESOP Finance/With Repayments Through The ESOP*—Under this alternative, ABC would implement an ESOP financing program by selling $1 million in newly-issued common stock to the ESOP at a price/earnings ratio of 10× net earnings after tax. The Company would also arrange for an ESOP loan to pay for the new stock. The loan would have the same terms as those described in the Debt Case, above, and would be amortized by annual cash payments by the Company to the ESOP and by the ESOP to the lender. These payments, under present law, are tax-deductible to the Company, within the limits specified by law which we assume to be adequate in this case. An analysis by ABC has shown that the Company's net earnings would increase to a level such that the newly issued shares would be valued, using a price/earnings multiple of 10×, at $4.1 million by 1995. Thus, the ESOP participants would, by 1995, have accumulated an equity interest in ABC Company worth $4.1 million. This is the same value as the pension plan assets considered in the cases above.

(e) *ESOP Financing/Tax Credit*—This case is the same as the ESOP Financing/With Repayments Through The ESOP case except that it is assumed the Federal tax law has been changed to make ESOP payments by the Company eligible for treatment as tax credits, rather than tax deductions. ABC Company felt it desirable to analyze the effect that this alternative would have on its financial performance.

TABLE 1.—TOTAL INCOME TAXES PAID

[In millions of dollars]

Period	No financing/ no pension plan	No financing/ pension plan	Debt financing/pension plan	ESOP financing	
				Expense	Tax credit
1976 to 1980	5.3	5.2	5.3	5.2	4.7
1976 to 1985	13.0	12.7	13.0	13.4	13.1
1976 to 1990	24.4	23.5	24.0	25.7	25.9
1976 to 1995	41.2	39.3	40.1	43.8	45.0

(4) To determine the contributions necessary to accumulate pension plan assets totalling $4.1 million by 1995, ABC Company assumed that the annual contributions would return 8% per annum through diversified investments in equity and debt securities. This rate of return is in line with historic returns realized in the U.S. stock market over the last ten years. ABC plans to make an initial pension plan contribution of $51,000 in 1977 and increase this contribution by 8% each year thereafter. In this manner, total plan assets would total $4.1 million by 1995.

RESULTS OF ANALYSIS

An analysis of each of the alternatives indicates that the various financing options would significantly affect the Company's income and balance sheet over the 1975–1995 period. Only the tax payments by the Company, i.e., tax revenues to the government, will be discussed here. The total taxes paid by ABC Company under each of the five cases are shown in detail in Attachment 1 at the end of this section and are summarized in Table 1 on the following page. As is seen, the total tax revenues over the twenty-year period depend upon the type of financing used. The various financing methods, ranked in the order of size of aggregate Federal tax revenues for the 1976–1995 period, are shown in Table 2 below.

TABLE 2

Rank	Financing method	Total tax revenues, 1976–95 (millions)
1	ESOP financing/tax credit	$45.0
2	ESOP financing/with payments treated as Federal tax deductions	43.8
3	No financing/no pension plan	41.2
4	Debt financing/pension plan	40.1
5	No financing/pension plan	39.3

This table shows that maximum tax revenues would be achieved if the annual payments to the ESOP by the Company to amortize the ESOP loan were treated as a tax credit instead of as a deduction as present law now dictates. In this case, the government would allow a generous tax incentive, the tax credit, as the loan is amortized. By permitting this credit, Government, rather than the Company has, in effect, amortized the ESOP loan. The Company is therefore able to retain excess cash which can be put to work in investments returning 10% after tax. This enables the Company to experience earnings growth at a rate substantially higher than the No Financing or Debt Financing cases and somewhat above the ESOP Financing/Deductible Payments case. Taxes on these earnings are at a level high enough so that, within eight years, the Government can recoup the initial revenues foregone by allowing the tax credit. By 1995, total tax revenues from ABC Company will be $45 million, more than $5 million higher than the revenues realized through the No Financing/Pension Plan case. Beyond 1995, tax revenues under the tax credit approach will increase at a higher rate than under the other financing methods.

The financing method which produces the next highest level of tax revenues is ESOP financing with the annual ESOP payments treated as a deduction for Federal corporate income tax purposes. Existing law requires this treatment. In this case, the Government is amortizing approximately half the ESOP loan by permitting the interest and principal of the loan to be treated as an expense. Half the cash normally used for amortization can be retained by the Company and put to work in investments yielding 10% after tax. Earnings growth will, therefore, exceed that realized under the Debt Financing or No Financing Cases.

These earnings are taxed at a 50% rate which allows the Government to recover the revenues initially foregone within six years after the transaction. Total tax revenues for the twenty-year period ending in 1995 will be $43.8 million, $4.5 million more than those realized under the No Financing/Pension Plan case.

The next highest tax revenue will be produced under the No Financing/No Pension Plan case. In this situation, the government has offered no tax incentives. ABC Company has financed all growth through internal cash flow. Resultant tax revenues have increased 8% each year and total $41.2 million for the twenty-year period ending in 1995. However, no pension plan is available for ABC Company employees which will, of course, mean that future Social Security benefits to retirees will be their sole source of retirement income—one known to be woefully inadequate.

The Debt Financing/Pension Plan case produces $40.1 million in tax revenues over the twenty-year period ending in 1995. In this case, the Government subsidized ABC Company by allowing tax deductions on the loan interest and pension plan contributions. However, because the Company was required to pay back the loan principal in after-tax dollars as well as half the interest and pension plan contributions, less capital was retained by the Company. The pension plan contributions are not retained as capital in the Company, as is the case in ESOP financing, and this reduction in capital results in an earnings growth rate that is lower than any of the above mentioned cases. Thus, total tax revenues for the twenty-year period are lower than the ESOP financing alternatives or the No Financing/No Pension Plan case.

The lowest tax revenue producer is the No Financing/Pension Plan case. The Government has allowed a tax deduction on pension plan contributions but the drain of capital from the Company caused by these contributions and the fact that no new plant was built to realize increased returns has resulted in an earnings growth rate lower than any of the other cases previously analyzed. Total tax revenue is, therefore, the lowest of all cases.

It should be noted that ABC Company has, under this alternative, a pension fund with assets of $4.1 million. By comparing the tax revenues for the No Financing/No Pension Plan and No Financing/Pension Plan cases, the front-end cost of establishing a $4.1 million pension plan can be determined. The No Financing/No Pension Plan case yields $41.2 million in total tax revenues whereas the No Financing/Pension Plan case yields $39.3 million in revenues, a difference of $1.9 million. Therefore, the government has, by allowing tax deductions on the pension plan contributions necessary to accumulate $4.1 million in pension fund assets, experienced a relative tax revenue loss of $1.9 million.

This conclusion is not surprising since it has been shown in the case of the two ESOP financing alternatives that near-term tax incentives, either tax credits or tax-deductible treatment, will result in tax revenues which exceed debt financing or no financing. It is simply a case of giving up a little in the beginning to get more back in the end. This is the strategy used by all investors and it should be no different for Government.

Figure 1 on the next page indicates the total income tax revenue over and above that realized under the No Financing/Pension Plan case. As is seen, aggregate revenues under the ESOP Financing/Expense case are lower than Debt Financing Pension Plan case or the No Financing/No Pension Plan case until 1982, six years after the financed transaction. Therefore, the Government has recouped this initial tax revenue within five years and, thereafter, will realize greater revenue than would be possible under all the conventional financing alternatives analyzed. Although the ESOP Financing/Tax Credit case is not illustrated in Figure 1, the initial tax revenue loss here would be recouped by 1984, seven years after the initial transaction. The rapid corporate income growth thereafter would result in the highest level of tax revenues over the twenty-year period.

Effect on Company and Employees

Although it is not our purpose here to analyze the effects of the various financing alternatives on the Company or on its employees, a brief comment on this subject would seem appropriate. It is desirable, of course, to structure legislation to benefit the corporations as well as their employees while, at the same time, avoiding large scale tax revenue losses. Since most corporations consider growth in net after-tax earnings to be one of their primary objectives, it is important to analyze earnings growth for ABC Company in conjunction with the tax revenues yielded by each of the five financing alternatives.

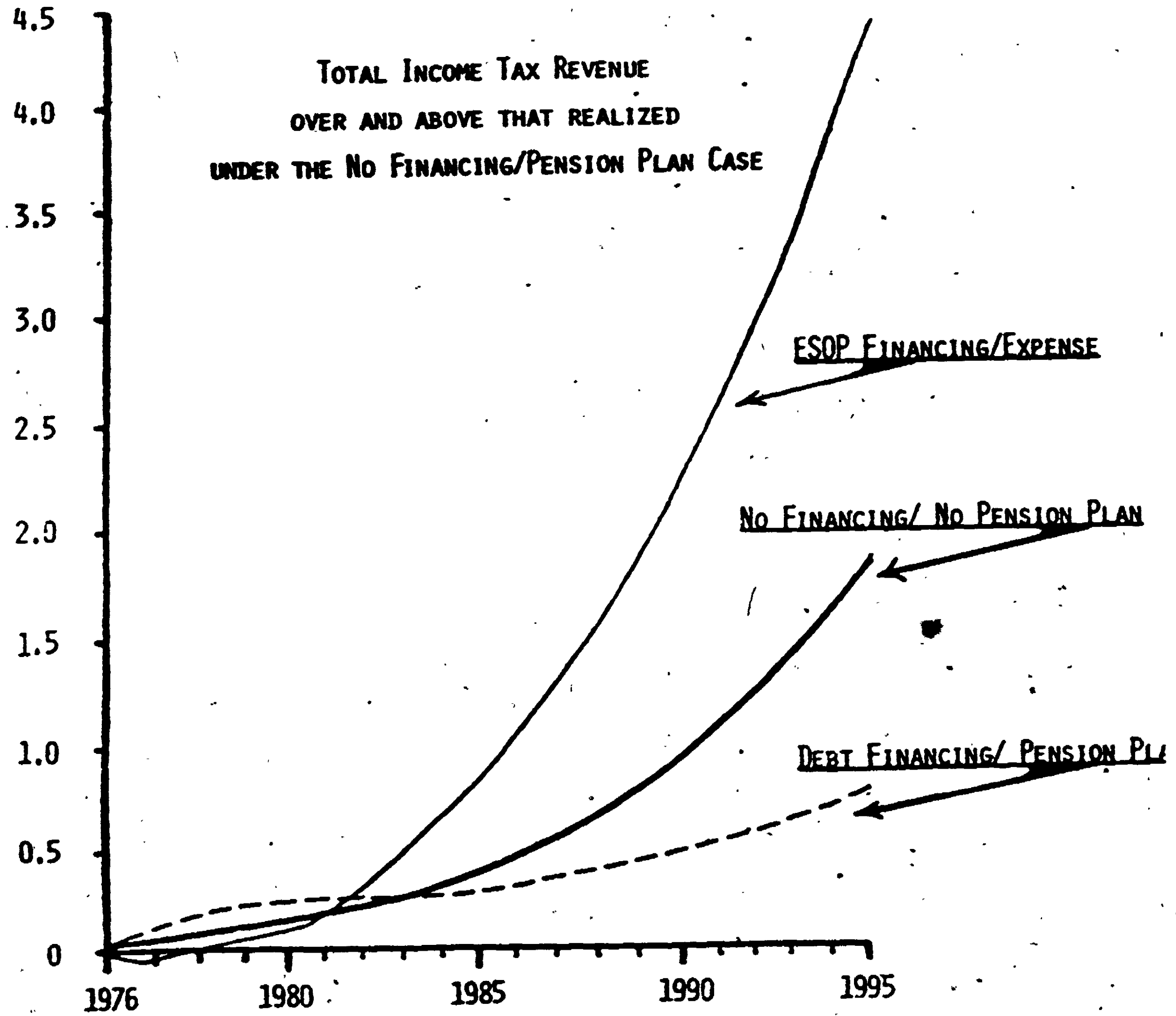


FIGURE 1

TABLE 3

Rank	Financing method	Net earnings growth (percent per year), 1976–95	Total tax revenues, 1976–95 (millions)
1	ESOP financing/tax credit	8.8	$45.0
2	ESOP financing/tax deduction	8.5	43.8
3	No financing/no pension plan	8.0	41.2
4	Debt financing/pension plan	7.7	40.1
5	No financing/pension plan	7.6	39.3

As Table 3 indicates, the ESOP financing programs have the highest earnings growth rates and also yield the highest total tax revenues. It appears, therefore, that adoption of the ESOP financing program will maximize the benefit to ABC Company as well as to the Government.

CONCLUSIONS CONCERNING FEDERAL REVENUE GAINS FROM WIDESPREAD USE OF ESOP FINANCING BY BUSINESS

This analysis has shown that the fears sometimes expressed by Senators, by Congressmen, and by the Treasury over substantial tax revenue reduction due to widespread adoptions of Employee Stock Ownership Plans are groundless. It has been shown that ESOP financing results in a lower tax revenue base for several years following the financed transaction but that these revenues are recouped within five to eight years. Thereafter, tax revenues will be greater, at ever increasing rates, than would be possible under conventional debt financing or with no external financing. The Government is, in effect, making an investment in business, by allowing short-term tax incentives, which will be reimbursed from added productive assets many times over. Of course, this is not surprising since investments are intended to do just that—pay for themselves and then continue to generate cash far into the future.

We have not here attempted to analyze the required outlays of the Federal government. We have only dealt with tax revenue as affected by various forms of financing. However, it is obvious that outlays, including those for Social Security and the ever-increasing welfare burdens of Government, will go down as the economic self-sufficiency of the people goes up. Because ESOP financing will serve to broaden the capital ownership base and provide a second income from dividends on the shares owned by ESOP participants, it seems clear that benefit payment requirements may be reduced if ESOP financing is adopted on a large scale. The combination of higher tax revenues created through ESOP financing and a simultaneous reduction in required welfare burdens should make it possible for Congress in due course to pay off the national debt and reduce all forms of taxation. Clearly, the benefits accruing to all through ESOP financing make this means of capital formation the most socially desirable of all financing techniques.

ABC CO.—TOTAL INCOME TAX PAYMENTS

[In millions of dollars]

	No financing/no pension plan	No financing/pension plan	Debt financing/pension plan	ESOP financing	
				Expense	Tax credit
For years 1976 through—					
1976	0.9	0.9	0.9	0.9	0.9
1977	1.9	1.8	1.9	1.8	1.7
1978	2.9	2.9	3.0	2.9	2.6
1979	4.1	4.0	4.1	4.0	3.6
1980	5.3	5.2	5.3	5.2	4.7
1981	6.6	6.4	6.7	6.5	5.9
1982	8.0	7.8	8.1	8.1	7.5
1983	9.6	9.3	9.6	9.7	9.2
1984	11.2	10.9	11.2	11.5	11.1
1985	13.0	12.7	13.0	13.4	13.1
1986	15.0	14.5	14.8	15.5	15.3
1987	17.1	16.5	16.9	17.8	17.6
1988	19.3	18.7	19.1	20.2	20.2
1989	21.8	21.0	21.5	22.8	22.9
1990	24.4	23.5	24.0	25.7	25.9
1991	27.3	26.2	26.8	28.8	29.2
1992	30.4	29.1	29.7	32.1	32.7
1993	33.7	32.3	32.9	35.7	36.4
1994	37.3	35.6	36.4	39.6	40.5
1995	41.2	39.3	40.1	43.8	45.0

ESOP FINANCING IS BUT THE TIP OF THE ICEBERG, THE VAST BULK OF WHICH IS GENERALLY UNKNOWN, AND THE BASE OF WHICH IS A CHANGED AND ENLARGED ECONOMIC POLICY OR FUNDAMENTAL OPERATING ECONOMIC CONCEPT WHICH WE HAVE CALLED "TWO-FACTOR THEORY"

ESOP Financing is but One of the Important Corporate Financing Reforms Structured upon Two-Factor Theory: The New Concept in Political Economy

ESOP

Public utility finance

Deflation design

Monetary reform to harness pure credit

Agro-industrial finance

Governmental planning to build purchasing power into consumers while expanding private enterprise

Privatization of publicly-owned enterprises like the Post Office and the Tennessee Valley Authority

Totally new technique of anti-trust divestiture financing, so that employees become owners, and so that new major competitors can be financed in monopolized or oligopolized markets

Recognition of a new and equally ominous form of monopoly not now recognized by law: personal monopoly of the power to produce wealth

Reform of the income tax laws to make the economically underproductive and nonproductive highly productive: a war on the cause, rather than on the effects of poverty

Reform of the estate and gift tax laws so as to raise self-sufficiency of consumers and prevent, for purposes of the economy, sterilization of productive capital in foundations

TWO-FACTOR ECONOMICS

THE CONSUMER STOCK OWNERSHIP PLAN (CSOP)

It is perhaps important only to note that joint financing proposals on the part of Kelso Bangert & Co. Incorporated, and Kidder, Peabody & Co., Incorporated, are pending before two of the Nation's largest public utility corporations. These would involve financing a small (but individually significant from the standpoint of employees) portion of the future growth of those utilities by using ESOP financing to build ownership into workers, and a large and unlimited portion of the future growth of those utilities by building ownership into utility energy consumers in proportion to their relative energy needs. This second phase of the proposals would, of course, require modest legislative changes both at the state and federal level and these will undoubtedly come before the respective state and federal governments within the next twelve months or so. It is important to know that the identical techniques, so far as economic theory and economic design is concerned, were used by Louis O. Kelso in designing the financial and ownership structure of Valley Nitrogen Producers, a large chemical fertilizer complex owned by some 8,000 or more California farmers, the overwhelming majority of whom paid for their stock entirely out of dividends. This corporation technically qualified as a cooperative, and thus could use the necessary tax advantages to build ownership into farm-consumers without their being currently taxed and without the corporation being required to include as taxable income the dividends it paid. It should be noted that the tax law has subsequently been modified to make this impossible, though its benefits to California agriculture and to the economy as a whole were enormous. We estimate that Valley Nitrogen Producers have saved California farm as a whole well over a billion dollars in fertilizer costs in the past fifteen years. Beyond this, it built the ownership of productive capital into many farmers who had never before owned industrial capital stock.

We believe that the proper application of two-factor principles to a regulated public utility would result in the use of ESOP financing to build a small portion of ownership into the utility's employees and CSOP financing to build the remainder of the ownership of future economic growth or the utility into public utility consumers in proportion to their service requirements. A brief functional description of the technique for building capital ownership into consumers may be useful to the Senate Finance Committee:

1. Escrow accounts with any designated banks, or with the public utility itself, would be established for each of the public utility's consumers.

2. By law the public utility would be given the power to mandate (that is, require) the subscription by each of its service consumers to their proportionate part (based on their relative estimated needs) of a ten-year moving capital budget of the public utility, covering the total capital formation requirements, except those financed through the utility's ESOP. Payments on this subscription would be synchronized with the utility's cash requirements. Methods for adjusting the subscription for over- or under-estimated needs would be designed.

3. Funds for the payment of each consumer's subscription would be provided by a consortium of banks, insurance companies, and perhaps savings and loan firms.

4. The subscriptions by each consumer would be payable solely and exclusively from the dividends received by the consumer from the public utility.

5. The public utility would be contractually committed, or perhaps legally required, to make a full pay-out of the proportionate earnings attributable to employees acquiring its stock through ESOPs and consumers acquiring its stock through capital-ownership financing escrows. Such dividends would be made deductible from corporate income for tax purposes, both at the state and federal levels.

6. The public utility's ESOP loan paper, and its consumer loan paper, would be made directly discountable with the Federal Reserve Bank at the minimal discount rate (½% at most, we estimate).

7. The effective interest rate to the borrower (the ESOP or the consumer escrow) regulated by the Eederal Reserve Bank to allow a reasonable profit to the immediate ESOP or CSOP lenders woudl not exceed 3%, and perhaps more closely approximate 2%.

8. Until the public utility's consumer stock has been paid for on a share-by-share basis, the dividends received would not be taxable to the consumer. However, as soon as the stock is paid for, again on a share-by-share basis, the dividends would become taxable income to the consumer, and would have the effect of offsetting, that is, reducing, the consumer's public utility service bill.

9. Thus the overall effect of the application of two-factor principles to public utility financing would be to hold down production costs, on the one hand, by providing employees with an increasing second income through their capital ownership, thus motivating them to restrain their demands for progressively more pay in return for progressively less work (as at present), while, on the other hand, raising the power of the public utility consumer to pay his or its public utility bills. The payout period on most financings would be four to five years, we estimate, at the contemplated interest rates.

10. The low interest rate involved in the use of pure credit in such financing is not, in any sense of the word, "subsidized" by government. It is simply the use of pure credit (the power of people to contract with each other in contracts performable on one side by the payment of money, in a society where all may enforce or defend their rights under such a contract) for the purpose of building self-sufficiency and productive power into the consumers of the society and for the purpose of motivating the employees in the economy. Nothing involved in the transactions enters into the government's income or capital accounts in any way. No governmental debt, deficit or subsidy is involved.

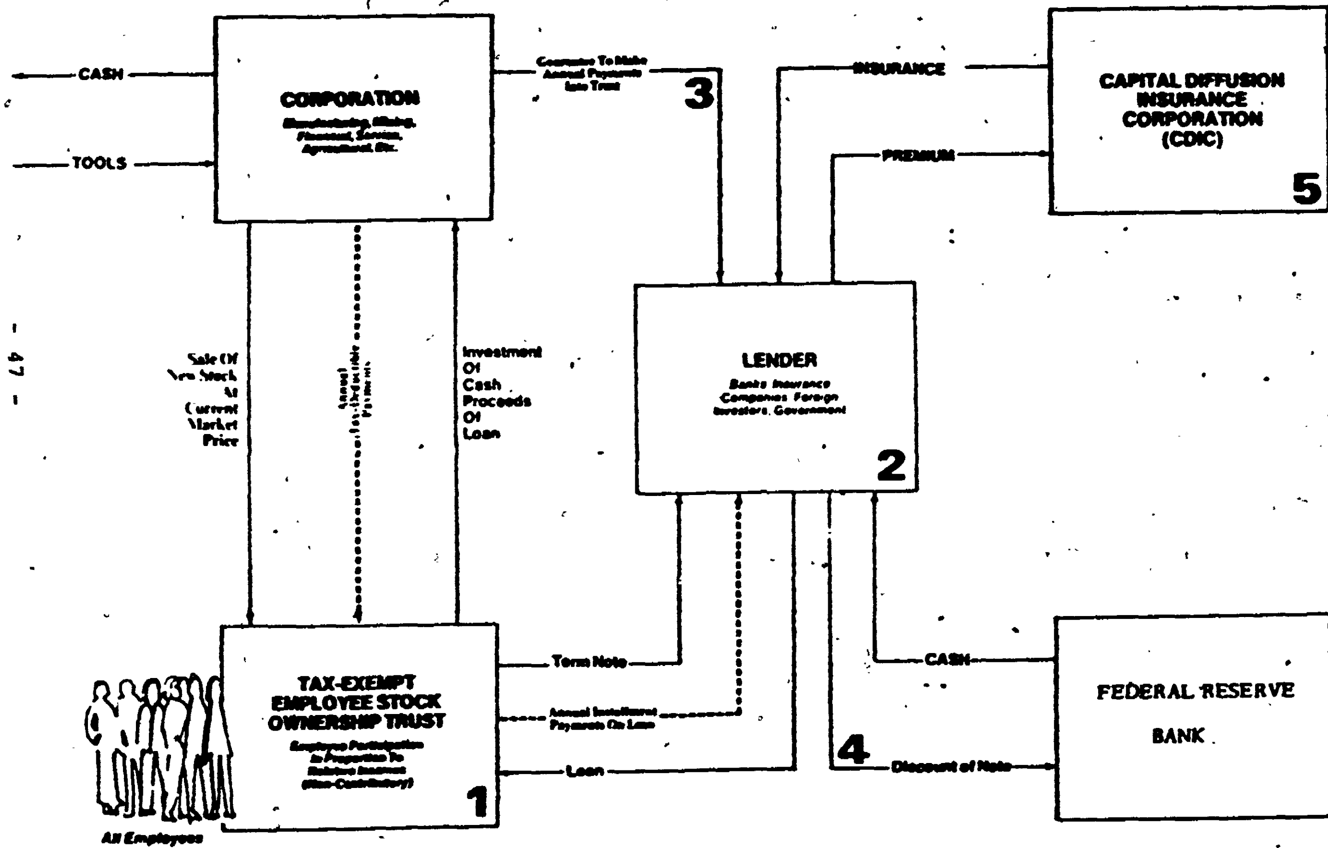
ADDING THE MISSING LOGICAL LINKS TO THE U.S. ECONOMY SO AS TO REMOVE ALL INSTITUTIONAL BARRIERS TO ECONOMIC GROWTH, CREATE FULL EMPLOYMENT, REVERSE INFLATION, AND BUILD ECONOMIC SELF-SUFFICIENCY INTO U.S. CONSUMERS

We are, of course, aware that so far as our proposals involve any change in the banking system, they should be addressed to the Senate and House Banking Committees, rather than to this Committee. At the first opportunity, we will seek to present testimony to each of those Committees on this subject. Nevertheless, in order to show the complete implications of a shift from a one-factor economic policy to a two-factor economic policy as the Joint Economic Committee of Congress is now recommending (see pp. 14 to 15 above), it is necessary here to outline the functional steps, as well as the relatively simple institutional changes, required to fully and effectively implement the new economic policy.

BLUEPRINT FOR A NEW ECONOMIC POLICY

The following diagram illustrates the use of pure credit to finance self-liquidating new capital formation in basic, well-managed businesses:

FINANCING ECONOMIC GROWTH BY MONETIZING PRODUCTIVE CAPITAL WHILE BUILDING MARKET POWER INTO CONSUMERS THROUGH EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FINANCING*



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1425

[Explanatory notes: Numbers refer to numbers on the diagram.]

1. The Employee Stock Ownership Plan (ESOP) Trust is a tax exempt entity organized to conform to Section 401(a) of the Internal Revenue Code. Not only are payments into it by the corporation deductible from corporate income tax within specified limits (maximum 25% of covered payroll), but the employees can accumulate capital ownership in the Trust until their retirement, free of annual income taxation.

2. In addition to banks, insurance companies, and foreign investors, all of which are currently eligible to make ESOP loans, consideration should be given to enlarging the power of savings and loan institutions to make such loans.

3. The corporate guarantee to make sufficient payments into the trust to enable the trust to meet its loan amortization requirements is, in effect, a pledge of the general obligation of the corporation payable in pre-tax dollars. In tax theory, this is a contribution to a qualified employee trust. In two-factor economic theory, it is merely a commitment on the part of the corporation to make a high payout of the wages (i.e., earnings) of the newly formed capital to the trust representing the beneficial owners of the stock. It is a tax-deductible payment of the wages of capital to the beneficial owners of stock so that they can first repay the costs of their stock and then receive second incomes from their capital. Under present law, tax-deductibility ends as to particular shares when they are paid for.

4. The direct discounting of the ESOP note with the Federal Reserve Bank should be strictly limited to basic financing of high priority, self-liquidating new capital formation, such as railroad rehabilitation, the building of new rapid transit systems, the expansion of agriculture, etc. It should never be used for consumer financing. The interest rate should be limited to the administrative cost to the Federal Reserve Bank and the administrative cost to the lender, including a reasonable profit. We estimate that the effective rate should not exceed 3% per annum to the ESOP borrower. The only cost of risk involved in the fixing of the interest rate should be the EDIC insurance premium. (See Paragraph 5 below.)

5. We recommend that Congress organize a capital financing counterpart of the FHA Insurance Fund which is designed for use primarily in the consumer housing field. Its name, suggested here, is Capital Diffusion Insurance Corporation. (For further discussion, see Kelso and Adler, The New Capitalists, Random House [1961], republished by Greenwood Press, Westport, Connecticut [1975]; Kelso and Hetter, Two-Factor Theory: The Economics of Reality, Random House Vintage Books [1967]; Testimony of Louis O. Kelso and Norman G. Kurland, Financial Markets Subcommittee of the Senate Finance Committee, September 24, 1973.)

6. This basic financing design, omitting the Capital Diffusion Insurance Corporation and the arrangement for discounting ESOP notes directly with the Federal Reserve Bank (both of which we recommend Congress provide for with the control conditions herein outlined), has been successfully used by more than one hundred U.S. corporations under existing law. The newly-enacted Employee Retirement Income Security Act of 1974 greatly strengthens and enlarges the opportunities for the use of ESOP financing. (See in particular Sections 404[a][2], 407[b], 407[d][3][A], 406[d][6], 408[b][3]) 408[e], 2003[a], 4975[d][3], 4875[d][13], 4975[e][7].

7. The diagram above, in stark and simple terms, demonstrates the enormous problem-solving power available to government through the use of financing techniques built upon the principles of two-factor economics.

The philosophical basis for the exercise of this power is simply the unquestioned right of each person within the jurisdiction of the United States to life. The right to life, in terms of two-factor economics, implies the right (and the correlative personal duty) to peaceably and legitimately produce the income to support life and make life comfortable at a level compatible with our resources, our technology, our manpower, and our know-how. Contrast the difference between this position and that taken by the supporters of the "guaranteed annual income," who hold that the right to life implies the right to receive a viable income irrespective of productive input. Proponents of the guaranteed annual income are strangely silent about the guaranteed perpetual tax servitude that this unavoidably implies for the rest of the population.

8. Inasmuch as the overwhelming bulk of our goods and services is produced through the input of the non-human factor of production—land, structures, ma-

chines, and to a certain degree, intangibles, such as firms and patients—the right of each man to produce the income equivalent of a good standard of living inevitably depends in part upon his ownership of significant productive capital.

9. Mere full employment of the labor force cannot solve the income distribution problem in itself, even though the law of supply and demand be totally disregarded (as today is virtually the case) in fixing the price of labor, for the productiveness of labor is not increased by paying it more than its market value, and the overpayment goes straight into costs; these costs eventually cancel out the overpayment itself and depreciate the value of the dollar by monetizing welfare. [See A. H. Raskin, "For Organized Labor, What Replaces 'More'?"; New York Times, September 1, 1975, copy of which is attached as Appendix X hereto.]

10. There is no practical means by which a person born without capital can legitimately acquire a viable holding of it except by using the logic which business itself uses, namely, by buying capital on credit on terms where it will pay for itself within a reasonable period of time, without diminishing his take-home pay or savings. His capital then will continue to produce income—a second source of income—for him.

11. The right to life thus implies the right to credit to be used to raise the economic productiveness of the non-productive and the under-productive consumers.

12. Because pure credit (as distinguished from the privilege of borrowing accumulated savings) is by its very nature social, an implicit social right, the way in which it is used, the persons to whom it is made available, and the purposes for which it is used, are proper subjects of governmental policy and governmental execution of that policy. Since pure creidt is nothing but the power of people (including juridical people, like corporations) to contract with each other under a system of law which enables everyone affected by the contract to enforce his or its rights with respect thereto, pure credit, the use of which is illustrated by the diagram above, is by nature a social (i.e. governmental) thing, and it is unlimited. Thus, this is a technique for eliminating all institutional barriers to economic growth, leaving only the physical limitations that industry and technology are well equipped to cope with.

13. It is of the most basic importance to realize that the proposed use of pure credit for well-managed, self-liquidating basic enterprise financing does not involve the government budget. It creates no governmental debt or liability. It does not enter into the Government's accounts.

14. Despite the removal of institutional barriers by the use of pure credit, physical limitations will, of course, remain. Physical limitations include manpower, resources, know-how and unsatisfied needs and wants. Their availability will affect the rate of economic growth achievable by this proposed policy change.

TWO-FACTOR FINANCING AS A GOVERNMENTAL PLANNING TOOL

The principles of two-factor economics, given the gravity of present economic conditions, suggest that government should identify those basic industries to be given access to low cost two-factor financing, both because of the inability of those industries to reach high enough growth rates without it, and because of the desirability of broadening their ownership base.

Specific allocations of this particularly favorable, low cost credit should be made only where the twin objectives of accelerating growth of a basic productive industry and of rapidly expanding the base of private, individual ownership of capital are determined to be present, and only for self-liquidating and financially feasible enterprises. For example, it would seem that, assuming sound feasibility criteria are met, financing for energy production, for rapid transit enterprises, for rehabilitation and expansion of the railroads, for new towns, for self-liquidating urban renewal and self-liquidating housing construction enterprises, for improvements to industry that protect the environment, and for other enterprises determined to be economically and socially desirable, would be given high priority.

THE REDUCTION OF INTEREST RATES THROUGH THE USE OF PURE CREDIT

High interest rates are now being maintained to repress accelerated growth and the inflation that inevitably results from trying to operate a two-factor real economy on one-factor principles. It is perfectly clear that such outrageous in-

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terest rates are inflicting enormous damage to the economy. High interest rates are causing economic pain and suffering to millions who are thrown out of jobs; they are strangling hundreds of thousands of small, medium and large businesses for whom credit is the very life blood; they are stalemating the formation of thousands of important new enterprises and expansion of existing ones. The policy of governmental selection of industries to be expanded, and governmental assurance that the expansion is limited to self-liquidating enterprises, with their long term (virtually perpetual) deflationary impact, means that interest rates on CDIC-insured loans discounted with the Federal Reserve Bank should be limited strictly to risk (covered by the CDIC premium), administrative costs of the Federal Reserve Bank, and reasonable bank, insurance company, or savings and loan profit. It would appear that such interest rates charged to the borrower should not exceed 2½% or 3% at the outside. This would release the brakes on growth of the real economy, while pushing it into a cycle of stability and gentle deflation. This would free up the use of existing savings of banks, insurance companies, and other lenders for consumer credit, venture capital loans, and, to the extent they wish to compete on the basis of the pure credit interest rate, for loans to finance basic new capital formation.

THE TRADITIONAL ARGUMENTS FOR HIGH INTEREST DO NOT APPLY

It should also be pointed out that the bankers' traditional argument for high interest, namely that the banks are only custodians of other people's money and must therefore obtain the highest return possible, although perfectly valid in respect to accumulated savings of others administered by them, has no applicability to instances where the pure credit of the people is used to raise the economic productiveness of the people.

CREATING LEGITIMATE FULL EMPLOYMENT THROUGH TWO-FACTOR FINANCING OF BASIC PRODUCTIVE ENTERPRISE

The use of pure credit contemplated by two-factor economics places in the hands of government full employment-creating methods far more effective than those emanating from Keynesian economic principles, and with radically different long-term effects. Keynesian deficit spending, implied if not commanded by our National Economic Policy, the Employment Act of 1946, creates jobs for the sake of jobs, and not for the sake of the things to be produced. Such spending is almost invariably for products that do not enter the consumer markets, since the very fact of significant unemployment implies a shortage of consumer purchasing power. On the other hand, increased employment generated by this proposed use of pure credit, thus making financable needed private enterprise that will liquidate its own financing costs, builds ownership into the employees, and in so doing expands their source of income and market power without inflating costs. This in turn will expand the production of useful goods and services, i.e., those actually intended to improve the quality of human life and to strengthen the economy.

The same technique of accelerating the initiation of self-liquidating basic private enterprise can be used by government to shift employment from public payrolls to enduring private enterprise. Thus, as the implicit economic policy begins to attack the cause of poverty of the masses by raising their productive power, the myriads of Federal and State employees, many of whom are administering only to the effects of poverty under numerous existing governmental programs, may expect to shift their employment to the private sector and to jobs that will enable them, over a reasonable working lifetime, to accumulate economic self-sufficiency in the form of a viable holding of productive capital.

THE HIGH PRODUCTIVE CAPITAL REQUIREMENTS OF THE U.S. ECONOMY BECOME ADVANTAGEOUS RATHER THAN DANGEROUS

One estimate of the cost of new capital formation for the U.S. economy during the coming decade is $4.5 trillion. (U.S. News and World Report, May 27, 1974, pp. 22–23.) This estimate, even with the institution of the gradual hardening of money, may well be conservative. That source of such financing do not exist under conventional concepts has been proclaimed by many economists, bankers, investment bankers, and political leaders. However, even if conventional financing could be found to satisfy such enormous capital requirements, the *distributive effects* of building the ownership of an additional $4.5 trillion or more of

newly-formed capital into the 5% of families who presently own all the productive capital in the U.S. economy—which would automatically occur if we continue to use conventional financing techniques—would be simply to shorten the fuse on the time bomb already ticking away within the U.S. economy.

On the other hand, the very magnitude of those capital formation financing requirements also indicates the unlimited opportunity open to the Federal government for building self-sufficiency into millions of American families, increasing their standard of living, reversing inflation, and increasing the basic economic power of the people—the ultimate assurance that the balance of power between the people and government will not in the future tip excessively in the direction of government. In other words, this is an opportunity to use a new form of government power to increase the individual power (economic power) of an ever-expanding proportion of the individual citizens. This should motivate those who are concerned with the preservation of individual freedoms to give their political support to a two-factor economic policy.

THE UTILIZATION OF ESOPS AND OTHER TWO-FACTOR FINANCING TECHNIQUES IN INTERNATIONAL ECONOMIC DEVELOPMENT

Only when the techniques of finance built upon two-factor economic principles are used by the great U.S. multi-national corporations to build market power and the ownership of productive capital into the citizens of the host countries in which those multi-nationals operate will the United States begin to solve the problems of economic development for the under-developed economies. Conventional financing techniques have not solved these problems, nor will they.

We know how to industrialize an under-developed economy, but without the techniques of finance here discussed, we do not know how to build commensurate market power into the citizens of the host countries. If we continue to build highly productive, foreign-owned enterprises in the developing countries, these in due course will be nationalized. In many cases, the result will be a net national loss of wealth to the United States and a mutual loss of good will between the U.S. and the countries involved.

On the other hand, building a reasonable proportion of the ownership of our multinational enterprises into the individual employees of the multinational corporations in the host countries, will, of necessity, open up fields of international development vastly greater than any heretofore available to us. An international constituency of employee-citizens of the host countries in which U.S. multinationals operate would be the greatest possible guaranty of their future safety and prosperity.

Why would the plan bring about a continuous hardening of the purchasing power of money?

The classical definition of inflation is too many dollars chasing too few goods. Since this plan is based upon the radical expansion of feasible and self-liquidating newly formed capital, it involves bringing into existence productive facilities that will not only pay for themselves once within a reasonable number of years (normally three to five), but will continue almost indefinitely to push goods and services into the markets without further capital costs, paying for themselves over and over again. The productiveness of the new capital instruments is preserved by depreciation practices. Furthermore, since the typical ESOP trust covers all of the employees of each corporation employing it for financing purposes, employees are gradually put in a position where their increasing wage demands conflict with their accumulating capital ownership; thus wage demands may be expected to flatten out. Since the typical ESOP trust is designed so that, once stock is paid for, any dividends thereafter paid pass through the trust into the employees pockets, it becomes possible to raise employee incomes without raising corporate costs. Furthermore, the ESOP, by building significant capital ownership into employees over a working lifetime, will gradually replace fixed-benefit pension trusts and profit-sharing arrangements that are invested only in securities of other entities, public or private, purchased for the most part in the secondary markets. Since these do not finance growth of the sponsoring corporation, they are pure costs which can be gradually eliminated through ESOP financing.

Finally, the rapid acceleration of the real growth of the U.S. economy, desperately needed and calling for large increases in employment, will render unnecessary the Government costs of creating make-work jobs producing little of market value. The rolls of the unemployed will fall and in due course many

Government employees will be attracted by the advantages of working in industry under conditions providing opportunities for capital ownership, second incomes, and economic security.

The accelerated growth of the economy will make the poor richer without making the rich poorer, and will provide a larger income and property tax base for Government. In the face of shrinking "need" of welfare demands, we can achieve every taxpayer's dream of a shrinking tax assessment, accompanied by increased purchasing power of the dollar.

CONVENTIONAL METHODS TO CLOSE THE PURCHASING POWER GAP OF THE POOR AND MIDDLE CLASS COMPARED TO THE PLAN BASED UPON ESOP FINANCING AND OTHER FINANCING METHODS BASED UPON TWO-FACTOR PRINCIPLES

Conventional Economic Expedients	*ESOP Financing Plan*
Attacks only the effects of poverty.	Attacks the causes of poverty.
Increases dependence of the individual on the State.	Creates growing autonomy, increasing economic independence of the consumers who produce progressively more of their income through their privately-owned capital.
Progressively more inflationary pressures.	Gradually deflationary through the hardening value of money. Living becomes easier because it is easier to produce goods and services and easier to buy and pay for them.
Demotivates economic activity through higher and higher taxes, redistribution and, discouragement of craftsmanship.	By linking the worker's performance of his job with the acquisition of a viable capital estate, provides him the most powerful and satisfying motivational force in history.
Restrains economic growth.	Promotes accelerating economic growth.
Economy increasingly depends on taxation and debt.	Economy increasingly depends on intelligent use of credit and the wise use of banking facilities to expand the private economy and enable all consumers to participate in production through capital ownership. The credit does not enter into the government budget or create government debt.
Numerous financial and institutional barriers to economic growth. "Where do we get the money?"	Institutional barriers to growth eliminated and only physical limits to growth remain.
Defy human nature because they violate Machiavelli's Law: "Men forget more easily the death of their father than the loss of their patrimony."	The economy in which capital ownership is broadly owned conforms to the nature of man because it helps him to acquire a capital estate, protects his patrimony, and helps it to grow.
Concentrates economic and political power in the same hands and is eventually totalitarian.	Keeps the economic power out of the hands of the State and diffuses ownership broadly through all consumers. The State remains in the position of umpire and guide. The freedom of the individual can be protected by the individual, while political power from election to election is centralized in an administration and in Congress.
Economic growth is limited by available financing and never rises above a fraction of its potential. Economic power shifts increasingly to Government as it becomes the main customer of more and more businesses. Credit allocation is designed to make the rich richer and to keep the poor poor.	While government has enormous ability to make low-cost credit available for broadly-owned basic new capital formation, and has therefore enormous leadership capability within the society, economic power in the form of the private ownership of productive capital remains with the people.

THE "BROADER STOCK OWNERSHIP PLAN" (BSOP) PROPOSED BY PRESIDENT FORD'S ADMINISTRATION IS TOO MILD TO RESCUE THE AMERICAN ECONOMY FROM SUFFERING THE FATE OF THE BRITISH ECONOMY

In his State of the Union message in January of 1976, President Ford approved of the idea of broader capital ownership in the U.S. economy by proposing his Broader Stock Ownership Plan. This plan was elaborated upon in recent testimony before the Committee by the Honorable William Simon, Secretary of the Treasury. Although this plan appears not yet to have been reduced to specific proposed legislation, the published releases concerning it, together with the testimony of Mr. Robert Walker, Undersecretary of Treasury for Tax Policy, at the hearings on ESOP financing before the Joint Economic Committee on January 11 and 12, 1975, and in the testimony of Mr. Simon before this Committee, would appear to contemplate a personal tax credit or deduction, within specified limits, to individuals who purchase investment securities and who hold them for a specific number of years.

In our opinion, such measures are not financing devices; they would promote stock market speculation in the secondary markets, that is, in the outstanding securities of corporations. But purchases of outstanding securities do not finance new capital formation. Furthermore, the revenue loss to the government would never be made up. It would simply be a permanent revenue loss, not one that brings about increased productive activity, which in turn would foster not only a restoration of temporary revenue losses, but an absolute revenue increase.

Such proposals, similarly, would seem to do little if anything to solve the enormous problems of financing new capital formation in the U.S. economy. Most economists and business and financial leaders believe new capital formation essential if the U.S. economy is to attain a growth rate that will enable it to cast off its malaise, and provide future Federal revenue increases.

CRITICISMS OF TWO-FACTOR FINANCING POLICIES AND TWO-FACTOR FINANCING TOOLS, AND ANSWERS TO SPECIFIC QUESTIONS THAT HAVE BEEN RAISED BY VARIOUS SENATORS AND MEMBERS OF CONGRESS

Are ESOP's (and CSOP's, too) a panacea?

In its March 1, 1976, issue, *Business Week* reported on the growing acceptance of ESOP financing in an article entitled, "Employee Stock Plans Begin to Catch Fire." In an editorial in its following issue (March 8, 1976, page 98) the Editor comments that "Enthusiasts for such plans see them as nothing less than panaceas. * * * ESOPs can have a legitimate role to supplement other employee benefit plans. But before Congress passes new incentives for setting them up, and before management embraces them uncritically, a lot more study of their long-range implications and potential for abuse is essential. Panaceas often have a way of turning into Pandora's boxes."

We would be the last to suggest that our proposals should not receive most thorough study by Congress before being enacted into law—where such enactment is necessary or proper. But we would like to point out that they have already received more Congressional study than most major pieces of economic legislation. Attached hereto as Appendix XI is an outline of the legislative history on employee stock ownership plans.

We would also point out that after four decades of trying to solve the problem of the failure of the U.S. economy to create a tolerable match between the economic power to produce income and the possession of unsatisfied needs and wants, it is perhaps understandable why a policy that clearly is sound and will work, and is practicable, can be mistaken for a "panacea", although it is capable only of solving the economic problems to which it addresses itself, and does not pretend to solve all of the world's woes. In other words, forty years of proposals that failed to work have so jadded the economic journalists that anything that clearly will work and is working looks like a panacea.

Copies of the *Business Week* articles from the issues of March 1, and March 8, 1976, are enclosed herewith as Appendices XII and XIII respectively.

RESPONSES TO SPECIFIC QUESTIONS RAISED CONCERNING ESOPS

The issue of Ownership v. Control is a delicate one, especially where unions are involved. What are your views on this subject, especially on whether there should be a mandatory pass-through of the voting power to employees on stock held by an ESOP?

Response. (1) We should say that the question of ownership versus control of the corporation is not only a delicate one, but one about which there has been much confused thinking, and, in Europe, much confused action.

Firstly, it should be recognized that the government of a corporation is a republican form of government, rather than a democratic form. Thus, the shareholders—the electors, or corporate electorate—elect a legislative body, the Board of Directors of the corporation. The Board of Directors, in turn, appoint management, including the chief executive officer, and such operating committees of the Board as it feels may be necessary to the proper governance of the corporation. The ultimate power, as in the case of a direct democracy, is held, under the laws of most states, by the stockholders. Thus at a stockholders' meeting, either special or general, the stockholders by majority of a quorum can override the selection of management made by the Board of Directors, and could, of course, absent restrictions in the by-laws or charter, replace the Board of Directors.

(2) "The question of control" of a corporation cannot be considered independently of the additional questions of "competence to control," and "control for whom, or for what?" Management is perhaps the most sophisticated and difficult art in the entire economic world. Thoroughly competent managers are as rare as perfection in any field of human endeavor. While much can be discerned about the ability of an individual to manage or control the activities of a corporation, or some part of them, from his education, his experience, his personal presence and rapport with other human beings, the ultimate test of a good manager is, of course, performance. The proper response to the question of "management of the corporation for whom? or for what?" should, it seems to us, be answered by saying that for those who take a long-range point of view (and we believe that this enormously important social policy question requires taking the long-range point of view), the proper object of management is the profitability of the corporation for its stockholders. Implicit in this answer are many things. The corporation that pollutes the environment will sooner or later be brought to heel by government's exercise of its police power, and perhaps made to pay dearly as the result of adverse public opinion of its potential customers. This can impair profitability. The corporation that does not treat its employees well will not obtain maximum performance from them; nor may it be able to employ the kind of employees it would wish. Thus, long-range thinking requires some identification of the self-interest of profit to the stockholders with a social concern for others, and a concern for the public interest and the environment.

(3) Two-factor theory assumes that any human being is qualified, merely by being a member of the human race, to own productive capital, and that ideally, all human beings would own viable holdings of productive capital in order that they may be economically self-sufficient, free of any dependence upon the charity of others or of the government, and that they may enjoy the dignity which goes with economic self-sufficiency. But, two-factor economics does not assume that every human being is qualified to hold a corporate management position. Management is, as I have noted above, a rare and difficult art. Good management is crucial to maximize the success of a corporation. It is neither in the interest of employees, as such, nor of stockholders, as such, nor of employee-stockholders, as such, that corporations be managed by inexperienced managers, incompetent managers, or amateur managers.

(4) Two-factor theory recognizes that there is a long history in modern law of separating management, or control, from ownership, and that these two things, control and ownership, are functionally distinct and different. The entire law of trusts is built upon the implied desirability, in certain situations, from the point of view of those having the decision making power, to separate the right to the economic benefits of capital ownership from the management of that capital. The model of the law of trusts is essentially that nominally followed by the modern corporation. However, in practice, one-factor economic theories, the prevailing National Economic Policy, corporate strategy and managerial science in general are simply oblivious to the basic duty of a trustee in such an economic circumstance: to account to owners for income produced and to pay it to them on some systematic basis. The Board of Directors and management, who, conceptually and, in U.S. corporations at least, in fact control the corporations (subject, again, to the ultimate power of a majority of the stockholders acting in concert, are not required to deliver the net economic product of the corporation to its owners, as the trustees of a private trust normally would be. Lacking this

responsibility, there is undoubtedly much more to be desired on the part of modern corporate management than it, in most cases, provides. Managerial mistakes may cause a loss of millions of dollars to the corporation, but, having no *right* to the payment of the full wages of his capital ownership, the stockholder cannot establish (in most cases) that such loss adversely affected his dividends. Thus, he is unlikely to take offense or to unite himself with his fellow stockholders in demanding better managerial performance or perhaps a new management.

(5) This picture is radically changed in the corporation where all employees—managers as well as such management employees—are stockholders; where their interests as stockholders (once their stock is paid for) is identical with that of public stockholders or even close-holding private stockholders. When two-factor financing techniques have been developed to the point where they provide wholly adequate alternative sources of financing, so that the corporation can, and if necessary be required, to respect the full rights of private property of its stockholders in their equity ownership, by paying out the wages of capital fully and regularly (though at longer intervals) like the wages of labor, virtually all of the control shortcomings of the modern business corporation will be eliminated. Stockholders can quickly ascertain that errors or incompetence on the part of management cost each of them individually; under such circumstances, stockholders could be depended upon to call management to account and to bring about improvement or change. At the same time, the interest of managers as stockholders in assuring the long-range profitability of the corporation is precisely the same as the interest of employee-stockholders who are below the management level, and of stockholders of the corporation who are not employees. The absurd conflicts that have risen repeatedly in the past, where management engages in activities designed to artificially elevate the price of the stock, in order to benefit them personally through the exercise of their stock options, and all similar practices based upon the interest of management, or the interest of employees, being different than that of stockholders in general, would cease. Similarly, as employees acquired significant stock ownership in the corporation for which they work, their interest in making excessive pay demands, in return for no increase in work input, must of necessity be tempered by their interest in avoiding impairment of the value of their stock in the corporation.

(6) It appears to us that employees in general who, either by nature or by demonstrated self-improvement, have not shown themselves qualified for managerial positions, have no place in the management of corporations. This is not to say that the corporation should not be an open institution, within which ambitious sub-management employees, by dint of achievement and self-development, can rise through the ranks to top management levels. This is most desirable, and most corporations abound with instances of such opportunity. But it is not in the interest of the employee as stockholder, nor even in the interest of the employee who does not own stock, and certainly not in the interest of stockholders in general nor of the economy itself in general, for a business enterprise to be subjected to amateur or incompetent management. Broad participation in the ownership of the corporation and broad receipt of the wages of capital are necessary in order that non-inflationary mass consumption can support mass production, and so that the economy can operate to achieve optimum advantages for the society. But broad participation in management can only be a prelude to incompetent management and deficient performance by the corporation itself.

(7) In line with the foregoing discussion, we believe that the voting of employee-owned stock held by an ESOP trust can be either by a committee appointed by the Board of Directors, or passed through the trust to the employees, through the operation of a proxy machinery by the trust committee for the benefit for the employee participants, as those in power may determine for the design of the ESOP. It should be remembered that the establishment of an ESOP is a collectively bargainable objective under existing law, and that if the voting of company stock by employee-participants, rather than by a committee appointed by the corporation's Board of Directors, is determined by employees to be a desirable thing, it lies within their power to achieve it. We do not, however, believe that the pass-through of the voting power to employees should be made mandatory. In the first place, such pass-through of voting power is not necessary where management is made responsible and where it discharges that responsibility well. Secondly, it will be difficult enough to achieve the broadening of the proprietary base of the U.S. economy sufficiently to prevent its decline to a

second or a third rate economy within the short time span we believe available to us to achieve this goal (five to seven years at most), without erecting any barriers to such necessary economic change. The imposition of mandatory pass-through of the voting, when pass-through can be achieved by labor itself if it deems it ultimately desirable, would be the imposition of an unnecessary and, we believe, undesirable barrier to the acquisition of capital ownership by many, perhaps most, employees.

How do you distinguish between the ESOP and the co-management program in Germany where union leaders sit on a management board? Is the German model a potential long-range threat to the union's natural adversary position?

Response (1) We believe that most of the basic distinctions between the use of ESOP financing to broaden capital ownership so as to include all employees, and the participation by union leaders in the management of a corporation, are essentially covered in our answers to the previous question. The European co-determination or co-management program, in our opinion, fails to solve the economic problem—the purchasing power distribution problem—which is of absolutely prime importance. It fails to add to the limited productive power of the worker the potentially much greater productive power of capital ownership. Thus it leaves the worker in a position where he must still continue to demand progressively more pay for progressively less work, except that he will be in a better position to achieve this destructive goal. Thus inflation, under co-determination or co-management, should rage on until it destroys the economies that employ it, or until government, in the interest of saving the society from total anarchy, becomes itself totalitarian and terminates political democracy, as well as any possibility of achieving economic democracy. In other words, it appears to us that the co-determination or co-management movement in the European economic communities and in the Scandinavian countries and in Great Britain manages to achieve the worst of both possible worlds: (a) it fails to solve the economic question of enabling economies to reverse inflation, accelerate growth, and enable citizens to be self-sufficient and taxpayers to be free of tax burdens to achieve income redistribution, while (b) it bedevils the businesses of the economy with amateur, incompetent management.

(2) On the question of whether the German co-determination or co-management model is a potential long-range threat "to the union's natural adversary position," we would say that it is not necessarily so. Different unions can fight among themselves to take over the management of a corporation, as can different factions within a single union. U.S. business today is being subjected to a constantly increasing number of "take-over raids" where one management is taking an adversary position against another. We would think that the co-determination or co-management movement, as such, would not reduce the opportunity, or even the reason, for civil strife within business.

(3) But an assumption is involved in the question just discussed as to whether a labor union has a "natural" adversary position, and if so, adverse to whom? The class-warfare school of labor relations is direct outgrowth of a defective economic policy that began, so far as we can tell, with man's origin, and has continued down today. Man ras not yet made an accommodation with technology or with the machine. Man's morality is built upon the idea that outtake should be related to input. So long as those concerned with the economic order of society and with the business world fail to recognize that a shift through technology of the burden of production off labor onto the non-human factor of production implies and requires a reverse shift in the financing of economic growth and changes in the ownership of capital from generation to generation that would provide opportunity for employees (and ultimately all consumers) to legitimately acquire the ownership of a growing capital holding, the "adversary" position of unions to management and to stockholders was indeed inevitable, though we think totally unnatural. It forced men to violate their moral nature by demanding progressively more pay for progressively less work. Aristotle pointed out that the nature of a thing should be judged by its tendency. The tendency of this defective economic policy, and of the defective corporate strategy following from it, is to encourage everyone to stop producing and live by taking the property of others. Obviously, this course can only lead the society to destruction.

(4) We believe that under a two-factor economic policy, implemented in the ways that we have suggested in this testimony, and in other ways that Congress, economists, businessmen, bankers, accountants, and others may find feasible, the

class-warfare school of labor relations will disappear, and the adversary aspect of the labor union versus either management or stockholders or the corporation itself will also disappear. Management and employees become co-workers and co-owners, and their interests as owners, of management employees, sub-management employees, and of non-employee stockholders become unified. This is the chief attraction, in our opinion, of a change to a two-factor economic policy: to eliminate the game of each segment of the economy taking its turn holding the society at whole at ransom in order to get what he wants, as Mr. Toynbee so well pointed out.

What is your tax philosophy on the wisdom of corporation income taxes compared to individual income taxes for paying the cost of Government?

Response. (1) We are very firmly convinced that the burden of taxes imposed by government should fall upon individuals, not upon corporations at all. The corporate income tax is a double tax on one of the two factors of production—capital. When the government taxes the income of corporations, it is merely weakening the property rights of the stockholder in his corporation. If the state and federal governments together take over 50% of the corporate net income, they have destroyed over 50% of the private property of the individual in his corporate equity. Perhaps even more important is the fact that, if we are to function as a democratic society, it is critical that individuals understand, and feel directly and personally, the burdens which government imposes on them, or perhaps more accurately, the burdens which they force government to impose upon them. Thus only when taxes are personal can the individual know through their impact what is going on between government and individuals in the economy. The mere elimination of corporate income taxes, however, would only be part of the measures required to fully invest the corporate stockholder with private property in his corporate equity. The ultimate restoration of that power would also require limiting corporate management to setting aside only operating reserves, and paying out the net income of the corporation (the wages of capital) fully and periodically, like the wages of labor.

(2) The question of timing is another matter. We would not urge the repeal of the corporate income tax while all of the capital in the U.S. economy is owned by a tiny minority of shareholders. We believe that to get from where we are to where it would be desirable to be—an economy in which every consumer unit produces the income that it desires for living, either through employment, or through capital ownership, or (preferably for the next two or three decades) both—the little-by-little repeal of the corporate income tax through the payment of the wages of capital fully to individuals who are building their first viable holdings of capital is the least disturbing and most productive way to eventually accomplish the total elimination of the corporate income tax. This would mean encouraging ESOP financing for corporate employees in all types of enterprise, ESOP financing and consumer ownership financing for all types of regulated public utilities, and eventually, once it is certain that the task of building an economy with a capital structure many times larger than our present capital structure is well advanced, the use of the financed-capitalist plan, as outlined by Adler and Kelso in The New Capitalists. This is the most workable and practicable method of correcting our past mistakes and approaching so close to the full elimination of the corporate income tax that it could then be formally repealed.

What is a good approach for integrating corporate and personal income taxes in ways that will simplify and make the tax system more equitable?

Response. (1) We believe that the broadest possible use of the two-factor financing techniques which we have outlined, and the development of additional two-factor techniques to meet special needs, is the best way of integrating the corporate and personal income taxes to simplify and make the tax system more equitable. These techniques would raise the economic productiveness of tens of millions of economically unproductive or economically under-productive people. They constitute a little-by-little repeal of the corporate income tax; they assure the elimination of future economic non-self-sufficiency for an enormous part of the population; and they would raise the tax base for income taxes, property taxes, gift taxes, and estate taxes, so as to diminish the tax burden upon all. It is the combination of eliminating the major portion of the Federal budget that finances welfare and boondoggle, and the building of the tax base itself, that will pave the way for any fine-tuning of the tax system necessary to achieve ultimate justice.

What kind of financing designs might be developed for cutting the costs of building mass transit systems, like the D.C. Metro, and new energy production systems?

Response. (1) Assuming, for the purposes of this question, that all of the enterprises involved are or could be made public utilities, we would suggest that a financing design be employed that would build a small portion of the ownership of these enormously capital-intensive enterprises into employees, and the remainder of the ownership of such enterprises into the public utility consumers. The technique has been outlined earlier in this testimony.

Won't your proposed monetary reforms put the Federal Reserve in the position where it will be directly allocating credit to individual borrowers?

Response. (1) We believe not. The financing of new capital formation in basic, well managed businesses, through ESOP financing and public utility CSOP financing and similar techniques, involve the borrowing by the ESOP, or by the consumer escrows (in the case of CSOPs) from existing commercial banks, insurance companies, or, if they should be qualified to make such loans, from savings and loan associations. Only the broad general rules would be laid down by the Board of Governors of the Federal Reserve Bank, pursuant to a Congressionally-determined policy of ceasing, to the maximum extent consistent with the laws of private property, making the rich richer, and, as an alternative, making owners of viable capital estates of the 95% of consumers who do not own such capital estates today. We believe that this process, as discussed herein, should begin with building capital ownership into employees in the case of non-public utility corporations, and partially into employees and partially into consumers in the case of public utilities. Within the broad policies and limitations laid down by Federal Reserve rules and regulations, the borrowers would be selected by the lenders in the conventional way.

(2) There would be, under the proposed two-factor monetary reforms, vastly less "loccation of credit" than has existed for decades in the past, since all of the evidence points to the fact that credit has been allocated to the rich and denied to those who do not own capital. It is through access to credit that the poor can legitimately become owners of capital, and yet, all of the qualitative studies show that 95% of the consumer units in the American economy own no productive capital of more than token significance.

Isn't it true that earnings per share would decline, at least initially, under an ESOP? Why don't you feel that this is a valid yardstick for deciding whether to adopt an ESOP?

Response. (1) If the ESOP financing plan is properly designed, there will be no more than a temporary reduction in "earnings per share" under the principles of two-factor economics. The guarantee by the corporation to the lender is simply a guarantee to make a high payout (ideally a full payout) of the wages of capital to the new beneficial owners of stock representing that capital, in pre-tax dollars (because it is the policy of Congress to encourage broader capital ownership by this means). There is invariably a close relationship between the period of time that newly-formed capital is shown by the feasibility study to be necessary to earn its costs for the corporation and the term of the loan made to the ESOP.

Thus to properly compute the per share earnings of the corporation, consistently with two-factor economic principles, one should add the after-tax earnings of the corporation (without deduction for the payment by the corporation either of dividends or of so-called "contributions" into the ESOP) to the aggregate of the payments (pre-tax) made into the ESOP. Payments of the wages of capital to the owners of capital are not corporate expenses, and should not be considered a reduction of corporate earnings, but rather the very essence of corporate earnings themselves. Obviously, accountants, and the Accounting Division of the Securities and Exchange Commission, must be convinced of the soundness of two-factor economics before they will concur in this view, but we believe the theory to be unimpeachable.

(2) Even accepting the erroneous view that payments by the corporation into the ESOP are "expenses, there is in many instances no decline in earnings per share as the result of using ESOP financing; or there may be a temporary decline in earnings per share, followed by a long-term increase in earnings per share. Much has been written in recent years to the effect that "earnings per share is a measure that emphasizes the present, but frequently disregards the long term (Wall Street Journal Editorial, March 7, 1973, p. 12). The implications of ESOP financing, like those of two-factor economics in general, should be appraised in the light of long-term effects. Shrewd financial analysts have urged abandonment of

earnings per share "altogether as a measure of corporate performance" ("Let's Abandon Earnings Per Share," by Joel M. Stern, Wall Street Journal, December 18, 1972, and related editorial). The factors involved here are:

(a) the tax savings to the corporation;

(b) the shifting (which may be gradual) from an irrational retirement system (pension or profit sharing plan) that involves investing in the securities of other companies (usually purchased in the secondary market where they do not finance economic growth, but only brokerage churning) which are 100% pure cost to the corporation, to ESOP financing under which the same dollar that finances corporate growth, finances employee stock ownership.

(c) the restraint that the gradual acquisition of capital ownership by employees will naturally impose upon their demands in the future for progressively more pay in return for progressively less work; and

(d) the fact that the corporation, through its ESOP, can finance its expansion on pre-tax dollars while simultaneously building retirement security into employees.

(3) There is clearly an awareness today, on the part of union members and leaders, as well as by non-union employees and the public at large, that demands for increased pay in return for decreased labor input (or in any event *without any increase* in labor input) are bringing about a reduction in the standard of living of all American consumers. Until there is a tradeoff that is sufficiently attractive and valuable to restrain this practice, the evidence is that it will continue. The one tradeoff that, of properly communicated and if properly supported by public policy declared by Congress and supported by the Administration, will be sufficient, is the tradeoff involved in an opportunity, over a reasonable working lifetime, to acquire a viable capital estate capable of enabling one to produce a decent standard of living beyond retirement or in the event of illness or technological unemployment. When these costs are added together, and some quantification given to the improved motivation that all evidence shows to exist where employees are aware that they are acquiring a growing ownership in their employer, the per share earnings decline should either be non-existent or brief. If it does exist, its brief existence will be followed by improved earnings to all shareholders over the long term.

Can you suggest ways of protecting workers against the downside risk that their stock values may decline from their original purchase price?

Response. (1) I have been told by insurance actuaries that insuring ESOP participants that the stock they ultimately receive on distribution, either upon separation from employment, or disability or death or retirement, will have a value not less than the value at which it was purchased by the ESOP or the value which was used for tax purposes in the event it was contributed to the ESOP, is an economically and safely insurable risk. Such insurance is now under study by at least one group in California. Clearly, such insurance would have to be written over a substantial number of companies to be sound and profitable. However, it is obvious that, decade in and decade out, the productive power of the American economy has grown, and that if we could eliminate institutional barriers, it would grow much more rapidly. We believe that such insurance should be explored by Congress, as well as by private insurers. Clearly, the writing of such insurance could be a function undertaken by the Capital Diffusion Insurance Corporation, which we discussed above.

What would be the tax impact of giving ESOPS the tax status of a charitable corporation? How can you justify treating the ESOP as a "charitable" entity?

Response. (1) I believe that the government would gain revenue from giving ESOPs the tax status of a general purpose charitable foundation. Once funds are put in a foundation, precious little tax revenue is collected from that capital or from its income thereafter at any level of government. Giving the ESOP the status of a general charitable corporation, in our opinion, would return the gigantic concentrations of wealth in the U.S. economy to the tax base: income tax, property tax, gift tax, and estate tax. We have asked many rich men whether, if they could achieve the same tax result, they would prefer giving part of their fortunes to an ESOP over giving it to a charitable entity, and they have uniformly answered "yes." Thus the government would gain, these holdings of capital would become connected with individuals who need such capital ownership in order to be self-sufficient and to avoid becoming wards of governmental or private charity, and the motivational effect, in giving hope to the 95% of people who

now cannot realize the American economic dream—the dream of acquiring a viable capital estate—would be enormous.

(2) We believe that the ancient Jewish philosopher Maimonides himself gave the proper justification for treating the ESOP as a "charitable" entity. He said that "The most meritorious of all [methods of giving] is to anticipate charity, by preventing poverty * * * this is the highest step and the summit of charity's golden ladder." (Translation from Matnot Aniyim 10,7 by Moses Maimonides, in The Union Prayerbook for Jewish Worship, Part II, The Central Conference of Jewish Rabbis, New York, 1962, pp. 117–118.) To the same effect is the following: "Greater, is he who gives, and greater still is he who lends, and with the loan, helps the poor man to help himself."—from Shabbat 63a. (See There Shall Be No Poor, Richard G. Hirsch, Union of American Congregations, Commission on Social Action of Reform Judaism, New York, 1965, p. 21.)

How do you justify treating dividend incomes as tax-deductible expenses?

Response. (1) Modifying the tax laws so as to make dividend payments into ESOP trusts, public utility consumer-ownership financing escrows, and the like, would simply be one cautious, but necessary, step in assuring that the owner of capital stock gets a full payout of the wages of the capital underlying his stock during the period that he is paying for that stock.

Corporation income taxes amount to about 14 percent of the total federal revenue intake. If every corporation takes advantage of your tax proposals, how will the Government pay its bills?

Response. (1) Accelerated corporate growth would breathe life into industries that have almost ceased to stir. It would stimulate the construction of new cities, the building of new housing, rapid transit systems, and the hundred of energy generating plants which have been cancelled during the past two years, as well as the rehabilitation of the railroads. Private sector growth would, of course, increase employment, which would in turn bring about a decrease in unemployment and welfare costs of every kind. Growing and eventually full employment would increase government income taxes. These developments would more than offset the government revenue lost, even with all corporations utilizing two-factor financing proposals to the fullest advantage.

(2) Again, the object of the plan is to build self-sufficiency into every consumer unit, eliminate the need for most welfare in the future, and to build up a tax base of such magnitude that taxation will be a negligible burden upon every taxpayer.

Is your form of ESOP truly universally applicable?

Response. The ESOP is but a single financing design constructed on the principles of two-factor economics. There are a number of different techniques designed either:

(1) to provide both low cost capital for the financing of economic growth, and to build broad capital ownership and incremental productive power into the economically underproductive (those with only their labor to sell) and the economically nonproductive (the unemployed or unemployable) ; or

(2) to achieve transfers in the ownership of capital instruments, for example, the transfer of ownership of a closely-held business from its retiring owners, in ways that broaden the ownership of capital and build economic productive power into the underproductive or nonproductive.

However, we believe that, except for the limitations arbitrarily imposed by law, as for example the size of the payroll base under which the amount of financing that can be channeled through an ESOP is limited either to 15% or (in the case of a combination trust) to 25% of covered payroll, the basic ESOP has universal applicability. It is applicable equally to capital intensive industries and to labor intensive enterprises; it is equally applicable to business enterprises in any part of the world. In short, wherever the economy seeks or requires the aid of technology, which is embodied only in the nonhuman factor of production—never in the human factor—and it is recognized as desirable to raise the productive power of individuals as a means of enabling them to receive higher incomes and thus enjoy higher standards of living, the ESOP is suitable to build the ownership of capital into employees who would otherwise own no capital or insufficient capital to enable them to produce higher incomes during their working lifetimes and to produce a higher standard of living after their normal retirements. Obviously, we are speaking here of enterprises involving the production of goods or services for market within economies designed to protect private property in the means of production. ESOPs are not

applicable to socialist or communist economies, simply because those economies deny that the right to privately own the means of production is a fundamental human right. Such societies are inevitably totalitarian, though the benignity of the ruling bureaucracy may differ from country to country.

It is the universality of the logic of business in private property market economies that makes the ESOP a universally applicable tool. The logic of business is the self-liquidating character of capital investments.

In service industries where little tangible capital may be used, the firm itself acts like, and has the basic characteristics of tangible capital, for the simple reason that the combination of the talents assembled by a profitable service enterprise is capable of producing a higher level of net income than the sum of net incomes that could be produced by the individuals working separately or in different combinations. Thus, the ESOP in a service enterprise enables the individual worker to acquire a share of the ownership of the firm. Individual workers can in such enterprises through an ESOP accumulate an ownership stake that will enable them, as capital owners, to produce a viable income after retirement. In service enterprises, as in capital intensive enterprises, the ESOP can provide a second source of income over and above the wage or salary earned by the employee. Many of our most successful ESOPs have been those established in service enterprises.

Is it possible to identify an types of corporations which would find an ESOP of little benefit or perhaps even harmful?

Response. The ESOP is of little benefit to a business corporation that, for whatever reason, is not profitable. The ESOP is no substitute for an enterprise being competitive; for good management; for a market for its products, etc.

Have you made any estimates at all as to the extent of tax loss to the Treasury from widespread adoption of ESOPs, particularly if the corporate income tax is terminated as you call for?

Response. This question involves a misunderstanding. We definitely do not urge the termination of the corporate income tax under the present pattern of concentrated ownership of productive capital. All of the qualitative studies of the ownership of productive capital in the U.S. economy made to date show that it lies almost entirely in the top 5% of wealth holders. To remove the corporate income tax under conditions even faintly resembling our present distribution of wealth; particularly of corporate stocks, would simply benefit the rich.

The only repeal of the corporate income tax that we can urge as desirable from every standpoint is the limited repeal involved in making payments into ESOP trust deductible as they are at present, or even better, as they would be if H.R. 462 were enacted.[1] The elimination of the corporate income tax involved in making payments by the corporation into its ESOP trust deductible from the corporate income tax is essential if the ESOP is to be sufficiently effective and efficient, if widely used, to correct the enormous maldistribution of wealth, and the resulting maldistribution of purchasing power existing in the American economy today, as well as to facilitate, at a sufficiently rapid rate, the financing of new capital formation within the economy. The widespread use of ESOP financing throughout all types of private enterprise, combined with the low interest rates attainable through the use of pure credit, as discussed above, is capable of enabling the U.S. economy to attain growth rates comparable to those of Japan in the past decade, with full employment, and with gentle but continuous deflation—that is, the hardening of the purchasing power of our dollar.

We have not made estimates as to the short-term possible tax loss to the Treasury through the widespread use of ESOP financing, nor do we believe such estimates are necessary to demonstrate that widespread use of ESOP financing will in fact cure the depression in the American economy and restore it to health, while eliminating its growing debt, and beginning to pay off and reverse that debt. A limited analysis of the Federal Government's revenue growth, following a brief period of years of revenue reduction, is set forth above. See pages 32 to 41. Our analysis is as follows:

(1) The chief difficulty with the U.S. economy is that its power to produce goods and services and its potential power to expand its production of goods and services is not matched by commensurate purchasing power in the pockets of

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[1] A version of H.R. 462, with some minor suggested changes, is attached hereto as Appendix XIV.

those who have unsatisfied needs and wants. Rather, increased production results in increased income to those who have no unsatisfied needs and wants, present or potential, who use that excess income to acquire, through conventional finance, further excess productive power, etc., etc.

(2) All governmental efforts to close this purchasing power gap—whether by outright welfare, or by subsidization of jobs in industry and in government—involve attacking the *effects* of poverty, while leaving its cause untouched. Since technology is a constantly accelerating force, the labor redundancy, as well as labor inadequacy that lies behind poverty today, must inevitably grow. Government's efforts to compensate for this trend by using deficit financing must increase at a corresponding pace until ultimate bankruptcy overtakes the entire economy.

(3) ESOP financing, accelerated economic growth through low cost capital and the use of pure credit, may have a brief inflationary impact and result in a brief increase in governmental deficit financing. But it contains the seeds of deflation; within a few years, increased productive power through increased new capital formation, increased corporate and personal incomes, and increased private employment would tend to restore the public revenues and ultimately the government's fiscal health. Thereafter the dynamics of rising Federal revenues and falling welfare and boondoggle costs would carry us into an era of unprecedented economic prosperity and fiscal soundness. Our own belief is that the cost of using financing techniques structured on two-factor principles on a widespread basis, even on a short-term basis, will be more than offset by savings in the financing of welfare and boondoggle.

(4) In short, the object of a two-factor economic policy, from the standpoint of the fiscal posture of the government, is to raise the productive power of the consumers as a whole, to eliminate the burden of redistribution and boondoggle that lies primarily behind government deficits and inflation, and to enable the government to gradually liquidate and pay off its debts, without impairing the rising prosperity of the economy.

(5) It is very important to understand that the discounting of ESOP financing paper with the Federal Reserve Bank does not enter into the national account of the government itself. Thus, the only possible cause of reduction of revenues would be the loss of the corporate income tax resulting from the deductibility of payments into the ESOP, to the extent that this loss is not offset by reductions in government welfare and boondoggle, increases in government personal income taxes, increases in gift and estate taxes of individuals, and after a brief period of years at most for each financing, great increases in corporate income tax revenues. (See pages 32 to 41 above.) In short, the object of a change to a two-factor economic policy to encourage ESOP financing and other methods of financing built upon two-factor principles would be to build self-sufficiency into the U.S. consumers as a whole, to eliminate the government's welfare burden, and build a tax base of unprecedented dimensions for income (personal and corporate), property, gift and estate taxes.

Relatedly, if the idea of expanding employee ownership and a greater sharing of the wealth are so laudatory and needed, then why is such a large tax break to the corporations needed?

Response. As before mentioned, the logic of business equity finance is, and always has been, to invest in capital on terms where it will first pay for itself within a reasonably short period of time (normally three to five years) and then go on throwing off net income indefinitely. But lacking a rational economic theory of a private property, free-market economy, our institutions were built under the guidance of some sound theoretical insight, heavily influenced by the personal greed of the wealthy individuals in power, and with heavy doses of simple business expediency, in such manner that for 150 years we were able to maintain an economic growth rate that looked good, compared with the economically primitive past, and still enabled us to turn in, as a national economy, an economic performance that was superior to all other countries on earth. Nevertheless, it was a crude performance compared to what it might have been had we understood what technology was all about, and how to harness it to the human society in such manner that we could maximize the production of goods and services, minimize toil, and maximize leisure, self sufficiency, and personal security.

It is true that the logic of business is to invest in capital on terms where the capital will pay for itself within a reasonably short period of years, normally

three to five years. But under conditions where state and federal governments take 50% to 60% of the wealth produced by capital before it can even be used by the corporation, and the principle of private property, as applied to the stockholders of the corporation, is wholly negated, as it is in every state of the U.S., so that the shareholders of a corporation have no *legal right* to their proportionate part of the annual net earnings of the corporation, then there is no opportunity on the part of the shareholder to buy common stock in the market place on terms where he can reasonably expect to pay for its price out of its yield.

In fact, exactly the reverse is true. With rare exceptions, and they have been extremely brief, the interest rate on personal loans has been higher than the yield of capital stocks. Nor is it adequate to say that in a few instances, the personal investor, had he sold his "investment," might have paid his interest costs out of his capital gains plus his yield, had he borrowed to purchase his stock. The end result is that he has a petty windfall of no investment significance, and has parted with the capital he might have retained had he been an "investor" rather than a "speculator" as the system forces him to be. Further, had the corporation, through its Board of Directors, determined to pay some part of the annual net earnings in dividends—something they are under no legal obligation at all to do—every income-taxing jurisdiction would have taken its bite out of those dividends once they reached the stockholder, thus assuring that his ultimate usable personal income from his capital stock would never pay more than a tiny fraction of the cost of purchasing that capital stock.

While it is true that the logic of corporate finance is investment in things that pay for themselves within a short period of time, it is not true that an individual can purchase capital stock representing either newly formed capital or existing capital, and pay for the price of that stock out of the nonexistent yield, or tatters of earnings which he may receive under conventional corporate practice. Perhaps in exceptionally profitable corporations, an ESOP might make it possible for employees to buy a diminished interest in the stock of their employer without such payments into the ESOP being deductible for corporate income tax purposes, provided that the further double mayhem of personal tax liability on income represented by accumulating stock interest, but not in a form usable to pay taxes, were somehow avoidable.

As noted above, the more fully we give corporate stock the characteristics of private property, i.e., the right of the owner of the stock to receive periodically and dependably the full yield, or proportionate net income of his equity in the corporation, the more fully, expeditiously and efficiently can we enable those who do not own capital to buy it, pay for it out of what it produces, and then own it and employ it to enchance their lives.

Technically, it is not a "tax break" for government to protect the private property of a stockholder in his right to receive the full wages of his capital before it taxes him. Private property is a basic tenet of a democratic free society. We have not accorded the ownership of industrial capital the same rights of private property originally accorded to agricultural private property simply because our economy was put together out of a patch work of expedients, in the absence of any comprehensive theory of capitalism.

The theory of capitalism dates from the publication of The Capitalist Manifesto written by Mortimer J. Adler and Louis O. Kelso in 1958. Prior to that there was no theory of capitalism; there was a collection of ideas believed to be characteristic of a capitalist society, but these were not part of a comprehensive logic. The word "system" means "logic." We cannot call our economy an "economic system" unless we can define its logic. The failure to accord the stockholder the right to receive the wages of his capital, paid periodically and dependably like the wages of labor, was simply one of those missing links in our concept of a capitalist economy. Nor was that link missing without reason. We did not have a method of providing adequate—much less unlimited—financing for the growth of newly-formed capital. Unless we permitted management to arbitrarily withhold the wages of capital indefinitely, economic growth would be totally stifled. The deductibility of payments into an ESOP trust from the corporate income tax only appears to be a "large tax break" because we have been conditioned to think of stock ownership as carrying no right whatsoever to the earnings produced by the underlying capital.

The corporate income tax is one of the chief incursions on the rights of the stockholder to receive his proportionate share of the total net income produced

by the underlying capital. The government intercepts the income in the corporation before it reaches the stockholder. As long as all of the capital ownership is in the top 5% of wealthholders in the economy, it would be a disaster to now totally repeal the corporate income tax. But, as noted above, it is a most desirable step in this direction to make the payments of the wages of capital to the beneficial owners of captial tax-deductible as they are paid to the ESOP for the beneficial ownership of the employee-participants.

When we have built an economy sufficiently large to produce a high standard of living for all consumers, and in that process have built capital ownership into all consumers so that they participate, on the one hand, in the production of the goods and services representing that high standard of living, and on the other hand, receive the income represented by their productive input, whether through their labor power, capital ownership, or both, it would then be appropriate, we believe, to repeal the corporate income tax altogether and to rely solely on the taxation of individual income. In this way, we correct the original mistake (the corporate income tax) while also correcting the concentration of the power to produce goods and services represented by the concentrated ownership of capital in the U.S. economy.

Up to now, ESOP's have been established and are currently being considered by corporations. Yet, only 22 percent of the labor force works for manufacturers and this is likely to drop below 5 percent in a few decades. Thus, aren t you really talking about a pretty narrow field in terms of all the promises you put forth concerning greatly increased rates of economic growth, universal capitalism, and a substantial reduction in transfer payments? How can all this be accomplished with so many working for Government and in services and particularly all the unemployed and those currently receiving welfare or other transfer payments?

Response. Of the 150 or more ESOP's established or in the process of being installed by Kelso Bangert & Co. Incorporated in corporations to date, only a modest percentage—perhaps no more than 20%—are in manufacturing corporations. The others are in various kinds of service enterprises, such as advertising, engineering, construction, banking, plant protection services, radio broadcasting, and the like, and in various trading, retail and other types of enterprise. The ESOP is as applicable to trade, service, wholesale, retail, and business corporations in general as it is to manufacturing. There is nothing peculiar to manufacturing that makes it unique in this respect.

In a book written by Dr. Mortimer J. Adler and Louis O. Kelso and published by Random House in 1961, entitled, *The New Capitalists: A Proposal to Free Economic Growth From the Slavery of Savings*, Adler and Kelso showed that the economy could build, with "the financed capitalist plan", capital ownership *into all consumer units within the economy*. We pointed out that because the productive power of an economy cannot be expanded many times over instantly, Congress would have to set the priorities determining into whom the capital ownership should be built. Congress, in making pure credit available to the people for this purpose, could, and would be obliged, from practical necessity, to determine, in broad categories, the priorities of groups having access to such credit. As has been said, the logic of well-managed private enterprise is to invest in capital on terms where it will pay for itself in a brief period of years (normally within three to five years), and then go on throwing off net income indefinitely, its productiveness being preserved by depreciation procedures that set aside funds for the restoration of wear, tear, and obsolescence before net income is computed. If this is so, and it *is* so, then it is only a question of financial and legal design, and the allocation of credit, that determine which persons become owners of newly-formed capital when it has paid for itself. Thus any group Congress designated, in whatever order, could become financed owners of productive capital. The elderly, or war veterans, or welfare families, are possible choices.

Obviously, our emphasis upon the ESOP indicates that we believe that corporate employees should have first priority right now. We are not going to be able to produce a high general standard of living unless we build the productive power to turn out a vastly greater amount of goods and services than we can produce today, while at the same time, financing the technological refinements necessary to protect the environment. This, we estimate requires the expansion of the productive power of the existing economy, on a per capita basis, by a factor of somewhere between 7 and 12 magnitudes. Such a titanic construction and production job will not be accomplished unless we fully employ every

employable person in the U.S., and unless those individuals are *motivated* to give their best efforts to the task. We estimate that the accomplishment of this goal will require somewhere between 25 and 30 years of the most intensive full employment; in the course of that period, the overwhelming majority of U.S. consumer units should acquire viable capital holdings that will provide them with economic security and independence, and the means of continuing to produce a good standard of living after they have retired from the employment world.

Thus, we would suggest that this 25 year plan should be well launched, perhaps 10 or 15 years downstream, before using the techniques of building capital ownership into people who do not take part in the construction and production of the "second economy."

In the long run, of course, we will achieve an economy that will provide us with a high general standard of living for all consumer units with only a fraction of the potential labor force being employed. Perhaps 10 years will be as long a time as any man or woman can be permitted to spend in the labor force three or four decades from now, if we believe it important that every individual spend some years in productive employment as a vital part of his or her practical education.

Obviously, in the interim, welfare measures must support those who cannot participate in the labor force: the elderly, the sick, the mentally deficient, etc. But as the productive capability of the system expands, and as employment in the private sector soaks up the unemployed and then begins to attract people from government payrolls; and as the need for boondoggle shrinks along with its costs; not only will society have adequate means to handle its welfare burden, but the welfare burden will progressively diminish.

In short, the task of building an adequately productive American economy is so crucial that we believe it would be dangerous to enable men and women who do not lend a hand to this task to acquire capital ownership as easily as those who do. While many public utterances would lead one to believe than man is a toil-loving creature, this does not happen to be the fact. If people in general could become affluent—in the practical sense—as easily without working as by working, they would take the non-work route.[1]

Won't the alleged increase in productivity upon corporate adoption of an ESOP be hindered by: (a) The fact that the second income won't be received for quite a few years, during which time many employees will probably leave; and (B) even upon receipt of the dividends, they will be such a small part of the employee's total compensation that they really won't motivate the employee in a new and significant way?

Response. This question involves a misunderstanding as to how a typical ESOP designed by Kelso Bangert & Co. Incorporated treats the problem of dividend distribution. The great majority of the more than 100 ESOPs that we have installed or are installing in companies in the U.S. contain provisions that, on a share by share basis, as stock is paid for, any dividends declared on the paid-for stock will pass through the trust into the participant's pocket. Thus, the flow of dividends, where a dividend-paying stock is involved, would normally begin with the first payment into the trust, which would pay for a specific number of shares that are then allocated to the participants' accounts. Dividends declared thereafter on those shares would then flow into the employees' pockets. The number of shares allocated, of course, increases from year to year; thus, the dividend flow increases from year to year.

It is quite true that the pay-out of dividends by U.S. corporations is relatively modest, although no one should underestimate the wonderment of the individual who has never previously received capital-produced income upon the receipt of his first few dividend checks. The size of the dividend income will grow as the use of ESOP financing grows and as Congress makes the ESOP progressively more effective in building significant capital ownership into individuals. Thus, a major portion of the dividend credit should be capitalized and transferred to the corporation's ESOP; such treatment should be made a condition to taking the dividend credit at all. The provisions of H.R. 462 (Appendix XIV attached hereto) and other legislation discussed in this paper, should be considered by

[1] For an example as to how financing techniques employing two-factor economic principles could be used to build capital ownership into welfare recipients, see "Income Maintenance Through Two-Factor Theory and The Second Income Plan," a memorandum for the panel of the President's Commission on Income Maintenance Programs at its hearings in Los Angeles, Calif., on May 23, 1969, by Louis O. Kelso.

Congress as means of accelerating the magnitude of the "second income" which employees can and should receive.

Finally, it is a basic tenet of two-factor economics that Congress should—even if this requires enactment of a Federal corporation law and mandatory compliance with that law by all corporations engaged in activities over which Congress has jurisdiction—protect the private property of the corporate shareholder in his right to receive his proportionate part of the net income of the corporation and to have it paid out regularly, not less frequently than annually. The essence of private property in producer goods (or capital instruments) is the right of the particular shareholder to receive the total proportionate share of the income produced by the capital represented by his shares. To the extent that such right does not exist, corporate stock does not represent private property ownership in the means of production. It is nothing short of scandalous that today the stockholder has *no right* to the earnings of the corporation in which he owns shares. The Federal government appropriates to itself 48% of the wealth produced by capital before it can be used by the corporation itself. The various states then take their bite. The board of directors may appropriate indefinitely 100% of the remaining earnings. Granting that withheld earnings were probably the only way to finance our (inadequate) rate of economic growth in the past, the techniques built upon two-factor theory eliminate this deficiency. They provide an unlimited source of financing growth while paying the wages of capital as fully and regularly as the wages of labor. Restoring the integrity of property in capital cannot, of course, be accomplished overnight; it could be totally accomplished within three or four years if we determine that we are going to make ours a truly capitalistic economy.

We strongly urge and recommend that the Senate Finance Committee give this subject its closest consideration and, if it ultimately agrees with these recommendations, that it throw its weight behind the restoration of privae property, or more accurately, the granting of private property to owners of corporate stock in U.S. corporations.

When private property is restored to the holders of corporate stock, and financing techniques that broaden the proprietary base become the primary methods of corporate finance in the U.S. economy, eliminating in the process inflation and unemployment, we believe that in a few years the major portion of every employee's income will be derived from capital. This will come about for the very simple reason that most of the goods and services in the U.S. economy are produced by capital.

Why should the new shares of stock be allocated according to compensation levels when this will just widen the present income gap between the vast majority of lower and middle income workers and highly paid executives?

Response. It is entirely possible that some U.S. corporations may overpay some of their executives. But it is also true that, as a whole, executives are the most strangely propertyless class in history. They may have high incomes; they certainly have high taxes and high living costs. Their aggregate ownership of capital—we are speaking now of professional managers, as distinguished from those who inherit significant capital ownership—is negligible. It is a rare event for an executive to retire with a capital accumulation large enough to support him comfortably without his social security and his pension. Even so, it is not uncommon for his standard of living to drastically drop upon his retirement.

The great disparity in wealth is not between corporate executives and other corporate employees; it is between the 5%—mostly inheritors of wealth—who own all the U.S. capital, and all the rest of the consumer units in the U.S. economy.

Management—good management—is a rare and valuable talent. The law of supply and demand decrees that it will be highly paid where, in fact, it is particularly well qualified and competent. On the other hand, we believe that the broadening of stock ownership among all employees, and the gradual taking of steps to establish private property in corporate stock of stockholders, will make the employee stockholders of a corporation, as well as the non-employee stockholders, extremely cost-conscious. An excessive executive salary means, under those circumstances, a reduced dividend. The pressure on management to be reasonable and responsive to the interests and wishes of stockholders in general, and to employee-stockholders in particular, can almost be guaranteed.

It should not be overlooked that the relative pay granted to employees of any enterprise is the best measure of the relative importance of that employee's con-

tribution to the corporation's income. Employees who believe their talents are worth more than they are paid customarily change jobs. It would be flying in the face of facts to assume that all employees are equally valuable; we all know otherwise.

Finally, while a few executives may be highly paid, it should be remembered that their stock ownership in the aggregate in most corporations would constitute a tiny fraction of the stock ownership of employees as a whole under the standard ESOP allocation. The ESOP allocation is as just as the wage payments; it would be difficult to see how greater economic justice could be achieved. Also, it should be remembered that under existing law, the Internal Revenue Service has the power to deny the deductibility of "unreasonable" salary payments. Perhaps the Treasury should be given Congressional encouragement to use that power more vigorously.

Why have you advocated that the shares allocated to employees contain no voting rights? Shouldn't owners of a corpartion have a say concerning the general policies of the company they own a part of?

Response. This question involves a misapprehension as to what we have advocated. We do advocate, in fact, precisely the opposite. We believe that only one of the 150-plus ESOPs that our firm has designed and established or is in the process of establishing in U.S. corporations involves non-voting stock, and that one was at the client's insistence, and contrary to our recommendation.

The function of the ESOP is to create an identity of interests on the part of public stockholders, management stockholders and submanagement employee-stockholders. This can best be done by using a single class of stock and by having voting rights attached to all such shares.

However, it is also true that the voting of shares in most of the ESOPs that our firm has designed and established is done by a committee, usually three or five persons, appointed by the board of directors, and subject to change or removal by the board of directors. In many cases, employee representatives are appointed by the board of directors to sit on the trust committee as a means of facilitating communication between management and employees.

A basic tenet of two-factor economics is that the function of ownership and the function of management are two entirely distinct functions. It is postulated that any human being can be an owner of productive capital (usually shares of stock in business corporations) and that, ideally, every individual would actually own a viable holding of such shares. However, it is not a postulate of two-factor economics that every individual is qualified to manage a corporation. The ideal corporation is one in which promotion from level to level in the corporate hierarchy is possible and easy. Nevertheless, management is a rare and difficult art; the health and success of the corporation as a whole depend on having the highest quality of management. Any sound employee communications program designed to facilitate an understanding of the company's ESOP will emphasize to all employees the vastly greater importance to them, now that they are becoming stockholders with growing stock ownership, of the highest quality, experience, and capability of the corporation's management.

A significant number of the ESOPs which Kelso Bangert & Co. Incorporated has designed and installed provide for the passing through of the vote to the employee-stockholder. Thus, the trust operates a proxy machinery for stockholder meeting purposes similar to that operated by the corporation for non-employee stockholders.

We believe that the best ESOP trust design is one which does pass the vote through to employees as the stock is paid for and thus gives employees a voice in the voting of corporate stock. However, we believe also that a number of years of living with an ESOP and learning to understand the meaning and significance and potential value of stock ownership—in other words, a period of education about capitalism and particularly about two-factor economics—should precede the passing through of the vote to employees where that vote represents control of the corporation.

Nothing could be more disastrous to a business than for stockholders to elect amateurs to the board of directors and for the board of directors to appoint amateur management. Such a corporation would stand out as a disaster to be avoided by all future businesses. Too long we have thought in one-factor economic terms. It requires education to think in two-factor terms, and the most important factor in that education is for Congress itself to give guidance to the citizens of the country in two-factor terms.

As of now, given the past experience of corporations with ESOPs and current tax laws and congressional acts related to them, is there any potential for corporate abuse or at least corporate financial gimmickry with no broader benefits to either the employees or society?

Response. ESOP financing is the most complex financing ever used by a corporation, for the simple reason that it affects the entire corporate personnel and the corporate personality. The implementing of ESOP financing involves a vastly broader spectrum of professional disciplines than that required for conventional corporate finance. Very few firms, to date, realize this, or are prepared to cope with this fact. What is more dangerous, no doubt, is the entry into the field of many a self-styled "financial advisor" with scant knowledge of two-factor economics, securities regulations, tax law, deferred compensation law, labor law and practices, investment banking practices, communications insight and capability, accounting, and so forth. Thus, it is inevitable that a certain number of ill-designed, and possibly even illegal, ESOPs will be esttablished and that some properly established ones may be mismanaged.

Nevertheless, the ESOP is about as fool-proof a device as human ingenuity can create for the purpose. Congressional recognition of the desirability of implementing broader capital ownership is encouraging some of the most responsible investment banking firms to establish ESOP capability, and Congress can do much more in this direction.

About the only potential for serious abuse lies in the possibility that a malevolent management or malevolent close holding owners, will sell a worthless business to employees through an ESOP. In other words, they will vastly overprice the business acquired by the employees. Fortunately, this risk, though it does exist, *is extremely remote.* The stock purchased by an ESOP must be paid for. Either the ESOP must borrow, on the corporation's guarantee, sufficient funds to buy the stock, in which event the entire transaction falls under the icy scrutiny of a lender, or the sellers must carry the credit themselves, and thus are dependent upon the business paying for itself within a reasonable period of years. If it does this, it has demonstrated that it was not such a bad guy in the first place.

Many possible legislative steps could be taken to further minimize this risk. Perhaps the most significant one is the provision of H.R. 462 (see Appendix XIV) that would permit a transaction to be reviewed by the Treasury in advance with respect to the valuation of stock to be acquired by an ESOP.

How do we answer the sporadic criticism of experts that ESOP financing should be abolished?

Response. Such attitudes are based upon views that do not comprehend the dire predicament of the U.S. economy and of all market economies on earth that follow the example of the U.S. economy. They are not realistic; they are typical of the resistance of the devotees of any discipline, school, science, or social science to any change whatsoever. For a superb study of this phenomenon, please see The Structure of Scientific Revolutions, by Thomas S. Kuhn (1970). University of Chicago Press. Some extracts from Mr. Kuhn's book are appended to this paper as Appendix XV.

Does investment by the ESOP wholly or primarily in the stock of the employer violate the spirit of the prudent man rule?

Response. Investment by the ESOP trust wholly or primarily in the stock of the employer does not, of course, legally violate the "Prudent Man Rule" for the simple reason that such investment is specifically authorized by law. The ESOP, and its predcessor, the stock bonus trust, are specifically intended by law to create or foster employee ownership of employer stock. But does such investment violate the spirit of the Prudent Man Rule?

In 1830 (Nine Pic., Mass. 446) in the case of *Harvard College vs. Amory*, the Supreme Judicial Court of Massachusetts, in a case dealing with the nature of the fiduciary responsibility of an individual who is investing funds for another laid down what has come to be known as the "Prudent Man Rule." The court concluded in general that the proper standard of responsibility for such a fiduciary was that of a "reasonablly prudent man" investing his own funds, with a view to preservation of the principal and optimization of the income, in order that he could live comfortably thereon, and perhaps even invest further. This rule has generally been interpreted as calling for the diversification of investments in order to avoid the possibility that the entire trust might be radically affected by having the single company in which it is invested get into financial difficulty.

We submit that the failure to carefully examine the "Prudent Man Rule" has led to more economic disasters, in terms of numbers of people involved, than would a total disregard of that rule altogether.

What has been overlooked is that the "Prudent Man Rule" deal with by the Massachusetts Supreme Judicial Court in *Harvard College vs. Amory* was a *rich man's* prudent man rule. It was sound advice as to how a rich man, or a fiduciary for a rich man, should act in order for the owner to remain rich while still living well on the yield of his capital.

But there is another prudent man rule—*the poor man's* prudent man rule. This rule was laid down by Andrew Carnegie in his biography in which he said, and we paraphrase him, "You want to be rich? It is easy. Just put all your eggs in one basket and watch the basket very closely." The distinguished Chairman of the Joint Economic Committee, the Honorable Hubert H. Humphrey, in a talk given in Stockholm, Sweden, on September 3rd of last year quoted the great American humorist, Mark Twain, to the same effect:

"Only a fool saith—Do not put all thine eggs in one basket. The wise man saith, 'It's okay to put your eggs all in one basket—just remember to watch the basket.' "

A moment's reflection is sufficient to realize that no significant fortune, American, European, or otherwise, was ever built under the rich man's prudent man rule; all significant fortunes were built using the poor man's prudent man rule. By applying the rich man's prudent man rule to the poor man—the worker—we have in our pension systems and profit sharing plans (with the exception of profit-sharing plans invested wholly or primarily in employer's stock—quasi-ESOPs) over the last half century managed to keep the poor man poor with exquisite effectiveness.

The ESOP applies the poor man's prudent man rule to the man who owns no capital. It puts him in a position of ownership in the only company whose profits he personally can influence—by working harder, by cutting waste, by persuading his fellow workers to do likewise, by making suggestions for improvement of efficiency, by fighting harder against competitors, and so forth.

Nor does it take much imagination to realize that if Congress should gradually extend the protection of private property to the holder of corporate stock, so that he would receive, as a matter of property right, the proportionate full wages of his capital (his proportionate share of the corporate net income) paid out periodically and dependably, the poor man's prudent man rule would be both more effective in relating the worker's performance on the job to his acquisitive instinct, and would enable him to live better when he shifts his total dependence, at retirement, to participation in production through his capital ownership.

One of the provisions of H.R. 462 (see Appendix XIV hereto) would apply the logic of this analysis to ESOPs. It would permit the Trust Committee, by consultation and negotiation with the participant prior to his retirement, to diversify his holding of company stock into a portfolio that he selects or that is selected for him by the investment advisor of his choice. Thus, the ESOP would first apply the poor man's prudent man rule to the capital-less worker until it builds a viable capital estate for him, and then it would apply the rich man's prudent man rule to him because he would then be in the practical sense of the word, "rich."

You claim that if your form of ESOPs were widely adopted, output could expand by 20–30% a year. Two very serious questions related to this claim are: (a) What about physical limits to growth? And (b) Wouldn't this rapid and greatly increased growth really be at the expense of other countries as the U.S. both absorbs the resources and bids up the prices of raw materials from its greatly increased demand? Doesn't it seem highly questionable that most industries can expand their output by 20–30% per year? For example, many service-oriented institutions such as life insurance companies and colleges, have no potential for such rapid expansion.

Response. (1) Some error has crept into our communications concerning the rate of growth which we would anticipate if the United States adopted a two-factor economic policy and began implementing that policy along the lines we have recommended. We believe that economic growth rates would begin to accelerate within one year from serious implementation of a two-factor policy, and that within four or five years annual growth rates of 10% or better could be achieved. We have never suggested that our growth rate could be stimulated

beyond that achieved by Japan in its best years—about 15% per year. We have estimated that it would take between 25 and 30 years to build a capital structure for the U.S. economy of such capacity that it would be capable, with an intermediately fully-employed labor force, of producing a high-general standard of living.

(2) We accept as sound the views of those scientists who believe that technology will always outpace resource depletion if the United States and other countries of the world will but significantly control their population growth rates. See for example The Next Hundred Years, by Harrison Brown and others (The Viking Press, New York, 1957). A revised edition of this book was published about 1967.

We do not subscribe to the views of scientific "Henny Pennies" who insist that the sky is falling. Even if we were to assume that at some point the U.S. growth rate, or the world economic growth rate, would be limited by physical factors, the changes in economic policy and corporate financing techniques which we have recommended are, we are convinced, critically necessary to achieve a more just and workable distribution of whatever levels of affluence we can achieve.

(3) In general, most of the underdeveloped economies are resource rich, as is the United States. We believe that the model which the United States economy can provide in demonstrating how a private property, free market economy can be operated for the benefit of all its inhabitants, rather than primarily for the benefit of a few, will be imitated by every free society on earth. We would estimate that the resources saved by solving these internal economic problems alone (through providing a working model within our own economy that others can follow) would begin to eliminate the world's poverty at a rate that would in turn reduce the prevalence of wars. Resources we squander in war and preparation for war would contribute greatly to the world's peaceful affluence.

(4) If the United States does not establish, by correcting the errors in its own economy, a successful working model of a private property, free market economy that functions well for all its inhabitants, giving them high standards of income, high quality goods and services, constantly hardening money supply (i.e., progressive deflation), expanding leisure and diminishing toil, the rest of the uncommitted nations will fall to socialism, as vast areas of the world already have. Nothing could more effectively diminish our opportunities for foreign trade in resources as well as in fabricated goods and in services. We must stop trying, as we did in Korea and Vietnam, to kill ideas with bullets. Bad ideas can only be killed with good ideas—and the only convincing good ideas are the ones that have proven superior in practice. The time for our actual fulfilling the world's expectations of us, and to demonstrate how a private property, free market economy within a political democracy, is the best form of economic system and best society for all peoples, is at hand. We have no time to waste.

(5) There can be no assurance that every industry or every business can achieve growth rates of 10–15% per year in the course of our building a sufficiently large capital structure to produce a high standard of living for all the American people. Growth is, and should be, responsive to economic demand. But service industries, like manufacturing industries, do expand in response to the demand of consumers with the economic power to buy goods and services to satisfy their needs and wants. Millions of people do not purchase insurance because they cannot afford to. And so with most industries, service and non-service.

When leveraged ESOPs are used as new techniques of corporate finance, all of the additional capital inputs must be profitable for the success of these plans. How can you assume that all companies will be able to simultaneously undertake such rapid expansion of output? What about the problem of saturated markets or do you feel that this will somehow not be a limiting factor?

Response. (1) All of our proposals assume the basic responsibility of business, on a company-by-company basis, to carefully determine the feasibility of each expansion, including the power of the market to absorb the added goods and services. Limiting factors on the expansion of business today are the lack of consumer dollars, inflation, and high interest rates. Through pursuit of a two-factor economic policy, we learn how to build productive power and its attendant purchasing power into those with unsatisfied needs and wants—something we have never before been effectively able to do. The growth of the economy and of the business within it would simply be in response to the increased incomes resulting both from the expansion itself, from the operations of the expanded econ-

omy, and from the fact that a rapidly expanding proportion of the population would begin receiving incomes—higher incomes—from two sources: their labor and their capital.

(2) We do not believe that it is true that "all of the additional capital inputs must be profitable for the success of these plans." Business failures are lower in periods of prosperity than in periods of recession, economic strangulation, and frustration, as at present. Nevertheless, errors will be made and failures will occur. The purpose of the suggested Capital Diffusion Insurance Corporation (CDIC) is to spread the risk of this failure over the broadest possible base of the economy.

(3) "Saturated markets" can only really exist when all consumer units achieve a high standard of living. At that point, and we estimate it will take 25 to 30 years under a fully implemented two-factor economic policy to achieve this, we will, as to all such "saturated" markets, have achieved the steady-state affluent economy. No further expansion is needed for all to live well. Then we need only to continue production at that level and make certain that all consumer units can adequately participate in production so as to enjoy a high standard of living.

Why should there be such a great expansion of private goods when so many people today feel that increases in the quality of life depend on better government services—for example, more parks, better health care, more and better mass transit, etc.?

Response. Our proposals are intended to make the overwhelming majority of our consumer units who are poor significantly more affluent. Affluent societies can afford, and do normally insist upon and achieve, improved quality in their social amenities: more and better parks, better health care, more and better rapid transit. Many of these, like health care and mass transit, would indeed be part of the expansion of the private sector financed as we have proposed, and broadly owned as we have proposed. Many such "government services" become government services only when the private sector institutions that originally provided them fail. Most such failures are the result of our defective economic policy and our resulting defective business financial practices.

Kelso has said that his three books make it emphatically clear that the second income plan is designed to make all poor people stockholder constituents of the major corporations. How would this be accomplished? Why the major corporations?

Response. More accurately, we should say that the objective of a two-factor economic policy and implementation is to make all consumers holders of viable capital estates, that is, capital estates which will materially increase their incomes, and upon retirement, provide them high livel incomes upon which to live comfortably. The size of the corporation is not important.

You've said also that ghetto residents must become owners of equity in corporations located outside the ghetto. What is the mechanism for this and the reasoning behind this?

Response. These discussions grew out of the so-called "Community Development Act" of the early Nixon Administration which was designed to assist ghetto residents in obtaining ownership of ghetto industiries and only ghetto industries. It appeared to us that the law would have built an economic barbed wire fence around each ghetto that incorporated itself as a Community Development Corporation. In general, it would make sense to help the economically weakest members of society to become holders of equities in the most powerful corporations. This is exactly what ESOPs would do for the great industrial populations. Two-factor financing techniques in general are capable of accomplishing this objective.

In providing for government employees, you have called for the "privatization of all public owned assets." Is the really feasible and how does the ownership of such assets produce a second income for the public employees?

Response, (1) There are a variety of two-factor financing tools for accomplishing the privatization of publicly-owned income producing assets, or assets that are capable of becoming income producing. For example, the privatization of the Tennessee Valley Authority, by a combination of ESOP financing and two-factor, consumer-ownership public utility financing (CSOP), would enable the employees and the consumers of TVA to purchase that enterprise, to pay for it out of what it produces, and thereafter derive incomes from their capital ownership. The same would be true of the Post Office, of the public utility facilities that revert to the Federal government upon the expiration of forty year leases of power sites on

government lands, of government owned ship building facilities, uranium purification facilities, and so forth.

(2) In the case of certain governmental operations that are capital intensive in the sense of requiring expensive capital structures, "facilities corporations" could be organized, either to finance the building of such facilities in the future, or to acquire existing facilities, or both. The facilities corporations would employ the governmental employees, would lease the facilities to the proper governmental agencies at fair market value, and would lease the employees to the governmental agency at cost. The adoption of an ESOP by the facilities corporation to accomplish the financing would thus build ownership of these income producing facilities into governmental employees, which ownership would take the place of the illogical and unbelievably wasteful and expensive pension systems which are bankrupting state and local governments and absorbing incredible amounts of government revenues today. Under such arrangements, the same dollar that finances construction of a government building would finance the ownership of these income producing facilities by government employees. The overall tax saving to taxpayers would be enormous.

How are new employees handled? Do they dilute the equity of workers already in the ESOP or do they just "sit by" until the next company contribution or loan for expansion occurs?

Response. (1) The ESOP, if properly designed, is an incredibly flexible device for accomplishing its goals. In the case of the so-called "leveraged ESOP," allocations of stock to employee accounts are made on an annual basis as the debt is retired. As new employees come in, they normally automatically become participants. As employees leave, they automatically cease to be participants in the sense that no further payments are made into their accounts for time thereafter, although their account balances may remain in the trust under a plan of installment withdrawal, and may continue to earn income applicable thereto. Since virtually every business has a continuous need for capital formation year after year, a long term employee will be receiving in his ESOP account allocations resulting from the amortization of numerous financings, in addition to such allocations as may result from investment tax credit ESOP stock allocations, or from gifts or bequests if H.R. 462 should become law.

How does your plan benefit older workers, who may be retiring before full vesting of their stock ownership? Aren't they more interested in a secure retirement income?

Response. (1) Obviously it is not possible to turn back the clock. Once an ESOP is installed, it operates prospectively only. Where an ESOP is substituted for an existing pension plan, the substitution is often limited to people who have at least ten years or so to work before retiring. As to the older workers, an existing pension or profit sharing plan may be continued in operation until they retire.

Should a scheme such as yours to expand equity ownership coerce or force people who have high risk aversion into higher risk situations where their return or benefit level is not guaranteed?

Response. (1) No "coercion" in the pejorative sense is involved in any ESOP. In the first place, employees are free to seek employment elsewhere if they do not like the employer company, or do not wish to own the employer's stock. Secondly, risk is a part of life, and so-called "fixed benefit" pension plans merely create the illusion that risk is eliminated. Actually they transfer the risk from the employee to the employer (and many employers are threatened with retirement system cost bankruptcy today). They accelerate the inflation that assures that the workers' pensions will be inadequate when they get it.

(2) Furthermore, it would be a simple matter in setting up a Capital Diffusion Insurance Corporation to insure lenders that make ESOP loans, just as the FHA program insures lenders that make FHA housing loans, to add an additional insurance program which who insure each ESOP participant, for a premium to be paid by the employer or by the ESOP trust, that he will receive at retirement in dollars not less than the dollar equivalent of the stock allocated by the employer to his account during his working lifetime. Indeed, a private insurance group is already studying the possibility of organizing a firm in California to sell just such insurance. This would simply spread the relatively rare risk of failure by credit-worth businesses over the economy as a whole. Significant business failures, once a rational economic policy is adopted and implemented, should be substantially reduced.

Over two years ago, you predicted that "unions will become the chief agents in spreading and accelerating the acceptance of two-factor economics and of financing techniques based upon these concepts." Why hasn't this come to pass?

Response. There is evidence, which it would be premature to discuss here, that this prediction will be fulfilled. Nothing more is involved than each labor union expanding its concerns and jurisdiction to comprehend both factors of production. Several wise labor leaders are already moving in this direction. One local of a national union has made the establishment of an ESOP its principal demand in its collective bargaining negotiations. The opportunity of unions to increase their constructive contribution to the American economy, to decrease their destructive contributions to it, and to increase their sources of revenue by receiving a check-off on capital ownership built into members—each suggests this change will come to pass.

Related to this is the problem that workers usually stay at their job on the average only 5–6 years. Therefore, many workers will never have their loan share paid up unless continuity mechanisms are produced. This would seem to have little motivating effect. Do you foresee any type of continuity mechanisms to alleviate this problem?

Response. (1) The "individual retirement account" (IRA) established under ERISA may well become the "continuity vehicle" by which workers, without adverse tax impact, can move their ESOP accounts from one company to another. The end result may be the holding of a diversified portfolio of stock by the time the worker reaches retirement age.

There is also the problem that in a large corporation, the worker is only one out [of] a very large pool of workers. So, there would not be that much concern for how your work effort would influence your dividend level. Certainly, there is nowhere near the motivation to the worker that there was to the individual farmer granted land under the Homestead Act, an analogy you often raise. How do you respond to this problem?

Response. (1) Irrespective of the size of an enterprise, if a worker owns a substantial block of shares in it, and the wages of his capital are paid out fully like the wages of labor, or so that his dividends on his beneficially owned stock form a significant part of his income, the common sense of the American worker will leave no doubt in his mind as to where his best interest lies: in doing the best job possible for his employer, in saving costs, and in promoting the profitability of the company. We believe that, motivationally, as much is gained through size under the circumstances as is lost in getting away from the high risks and frustrating vulnerability to the vicissitudes of nature on the "family farm."

Will worker alienation really be significantly diminished through adoption of an ESOP? Aren't there other basic causes, such as the organization of work and what the employee has to do day-in and day-out, which are more fundamental to their alienation?

Response. It seems to us that the chief source of worker alienation is the erosion of the adequacy of the worker's labor power to support him, resulting from technological advance, and his awareness that he increasingly relies upon coercion rather than performance for his income—the morally unfortunate position that a one-factor economic policy has put each worker in. As his growing capital ownership not only restores, but indeed enormously enhances his productive power, he will gain pride and interest in his employer and in his work. We doubt that most workers, in jobs providing them with good incomes and the prospect of retiring economically self-sufficient, are as much concerned about the "monotony" of industrial work as it now appears. Work of every kind, with the rarest exceptions, nivariably involves monotony, and always has. Common sense tells the worker that monotony is a reasonable price to pay for being economically secure throughout his lifetime This is not to say that the work place should not be made as pleasant as is reasonable, and as interesting as is reasonable But where monotony on the job produces a good income and the purchasing power of the dollar is growing year by year, as it will when inflation is reversed, the employee will look to the time he spends off the job for his diversions, his excitements, his amenities, and most of the things that make up the quality of life His job will not be his whole life, and it should not be.

If ESOPs are so inherently attractive, both for the corporation's future growth and for the benefit of the employees, why are there only about two hundred companies which have adopted them and why are all of these companies quite small?

Response (1) It is no secret that smaller companies are more innovative than larger ones. Nevertheless, the Joint Economic Committee in December, 1975, saw the most serious and intensive sort of study of the possibility of adopting an ESOP by American Telephone and Telegraph Company. Other major public utilities and manufacturing corporations have established or are giving the most serious consideration to the adoption of ESOPs, as noted above. Press reports indicate that Standard Oil of California, Mobil Oil Corporation, ARCO, and a number of other corporate giants have adopted ITC–ESOPs.

(2) We believe that the one missing link to a great expansion in the number of ESOPs is Congressional guidance both through a formalized statutory change in the National Economic Policy such as that set forth in the Appendix to Two Factor Theory: the Economics of Reality, and through Congressional adoption of the minor reforms herein urged that would make ESOP financing far more efficient and attractive, both to businesses and to employees, and to their unions.

Since you have promoted ESOPs as a means to spur future growth through new capital formation, does it bother you that most ESOPs currently in existence and those being discussed for possible adoption do not involve new capital formation? Rather, they are used for transfers of ownership, for re-financing existing debt, as alternatives to selling stock to the public, for public-owned corporations going private, for the financing of acquisitions and for divestitures, and for solving estate liquidity problems?

Response. (1) Achieving the goal of broad capital ownership, ultimately by all consumer units in the U.S. economy, is as much dependent upon assuring that as generations of capital owners die, the method of succession used advances this goal, as it is upon broadening ownership of newly-formed capital in the course of financing expansion. The ESOP is the most ideal device ever designed for converting closely held ownership into broadly owned enterprise under these circumstances.

(2) At current interest rates, the financing of new capital formation is in trouble, no matter how it is done. A southern power company recently issued 14% bonds! The moment that low interest credit is made accessible to basic, well managed businesses to finance their growth, as proposed herein, we predict that the rate of new capital formation through ESOP financing and other types of two-factor corporate finance will accelerate spectacularly.

Isn't it true that for such companies as Brooks Camera, Mulach Steel and Hallmark, the owners were simply creating markets for their shares upon retirement? Would you support legislation to limit ESOPs to issuance of new stock so that they truly would promote new capital formation in this country?

Response. (1) In each of the cases mentioned above, there were conglomerates and competitors standing by to purchase the companies. The owners, in each case, simply chose to sell to their employees out of a belief that they owed this opportunity to their employees, once the ESOP technique had been perfected for their use.

(2) Because it is just as important to broaden the ownership of existing capital as it is to broaden the ownership of future newly formed capital, we would hope that Congress would see the wisdom of not adopting legislation that would cripple the use of ESOPs to enable close-holding owners to sell to their employees. In most cases, if close-holding owners were selfish, as they are often prone to be, they would merge their enterprises into a conglomerate and further concentrate the ownership of capital in U.S. enterprise. Only the most enlightened close-holding owners have used ESOPs to date. Congressional guidance encouraging this is desperately needed by the economy. Similarly, the enactment of H.R. 462, with its provisions which would permit a close-holding owner to achieve the same tax advantages by transferring great blocks of stock to an ESOP trust that he would otherwise gain by socializing his fortune through placing it in a general purpose charitable foundation, would also help to broaden the ownership of existing capital.

Is it possible that workers acquiring equity in a declining or failing company may not be successful in turning the company around? Should the government, through the CDIC, be put into the position of aiding workers to buy unsound stock and 'hold the bag' for them? You make a big point of eliminating government subsidies which you term "boondoggles.' Yet, on the other hand, you create this new powerful government entity, the CDIC. How do you reconcile these two points?

Response. (1) CDIC, if government organized (it could be a group of private insurers) would be as fastidious as any insurance company in not insuring un-

sound risks. Similarly, the Federal Reserve Bank, should ESOP financing be made discountable therewith, would certainly adopt administrative procedures to prevent the making of loans to failing or unsound companies. The freedom to fail has to be a part of any free society, and the freedom of financial instiutions not to make loans to unsound enterprises is equally important. It would be a misunderstanding to assume that we have ever recommended ESOP financing for failing companies or that we believe such to be a proper use of it.

Is there a problem for a company which must retract its work force since it then must pay out substantial amounts of cash to the ESOP participants which are non-deductible?

Response. (1) A properly designed and operated ESOP is subjected to periodic liquidity analyses to enable it to meet such contingencies. Distributions from the ESOPs are in stock, not in cash. The rate at which, in a non-public corporation, the ESOP repurchases stock from retirees can normally be adjusted to accommodate the facts.

Aren't the officers and directors of the corporation which is in poor financial condition leaving themselves open to personal liability for utilizing an ESOP to dispose of shares that could not be marketed in any other way? How can it be said that this kind of arrangement is for the "exclusive benefit of the employees"?

Response. (1) The answer to the first question is "yes." Selling shares in a failing company to an ESOP by insiders would violate the Internal Revenue Code provisions against selling at more than "fair market value" or "fair value" if there is no public market. ESOPs are not recommended for failing companies, but rather for healthy companies that wish to grow in a healthy way, to contribute to the health of the economy.

Would you agree that the "tax status of any corporation considering an ESOP is of fundamental importance?" Then, what about the many corporations, usually among the giants, that pay little or no tax? For example Ford, Lockheed, Honeywell, American Electric Power, Consolidated Edison, LTV, and Chase Manhattan Corporation, Texaco and Mobil. Of what real benefit is an ESOP to them?

Response. (1) Many corporations, including giant corporations, fail to make profits because we have a floundering economy. It lies within the power of Congress to put the U.S. economy back on the road to prosperity, accelerating growth and profitability by expanding the National Economic Policy in the manner urged in our testimony. Only a defective economic policy and a defective corporate financial strategy built on that policy could explain the non-profitability of the giant corporations cited in the question—and of many others. In short, the reforms proposed in this testimony should return our corporations, great and small, to profitability and to the status of high taxpayers.

If contributions are limited to 15% of payroll, how can this possibly help a highly capital-intensive firm such as the oil companies? Wouldn't the value of new equity shares be quite small relative to their net worth?

Response. (1) the answer is "yes," although the actual limit under present law is 25%, rather than 15%. H.R. 462 would remove this limit and thus go a long way towards helping to solve this problem. Similarly, corporations whose employees would become excessively affluent should naturally be among the first considered for application of the broader capitalist plan which can be used to build capital ownership into any group (the elderly, government employees, school teachers, civil servants in general, welfare recipients, etc.) within the economy, under priorities determined by Congress.

To the extent that ESOP financing is categorized as debt, doesn't it limit the borrowing capacity of a corporation since a lending institution will consider the fixed nature of the corporate obligation to the ESOP lending it additional funds?

Response. (1) Setting aside for the moment the fact that an obligation to pay beneficial owners of stock the full wages of their capital is *improperly* categorized as "debt"—a problem yet to be worked out with accountants unfamiliar with two-factor economics—our experience with lending instiutions is that they are far more ready to make loans repayable in pre-tax dollars than loans repayable in after-tax dollars. Again, carefully considered legislation clarifying the fact that a corporation's obligation to pay out earnings relatively fully is not a debt would be extremely helpful. Congress should take steps to invest the stockholders in U.S. corporations with true private property in the capital represented by their stock.

You speak highly of the "second income" resulting from the distribution of dividends. Won't this adversely affect the corporate cash flow after this distribution, making it lower than it would be under traditional debt financing where no dividend burden is present?

Response. (1) Technically, a corporation's "cash flow" is improved when it finances its growth on pre-tax dollars rather than after-tax dollars. Giving corporations access to vastly greater financing sources through the Federal Reserve discount procedure would far more than offset any disadvantage resulting from vesting corporate stock with the attributes of private property, i.e., requiring corporations to pay out the wages of capital to their owners (the stockholders) regularly as an aspect of their rights of ownership in the corporation. From the standpoint of the corporation, its sole concern should be that it has adequate financing. We think that we have demonstrated such adequate financing can be obtained through the use of the ESOP technique or of other techniques built upon two-factor principles, provided the financing paper is made discountable with the Federal Reserve Bank and the effective interest rate comprehends only actual administrative costs, and reasonable profits of the immediate lenders.

If ESOPS became widespread, the bank credit used would result in a much greater increase in the money supply than at present which would be fed into a demand for goods and services immediately. Therefore, isn't this program an engine of inflation?

Response. (1) It is of central importance in considering this question to remember that ESOP financing, and indeed all financing built upon two-factor principles, is aimed solely at providing credit to enterprises that will, in the judgment of experienced lenders, and in conformity with such precautionary rules as may be laid down by the Federal Reserve Bank, pay off their financing out of their operations within an acceptable period of years. At the outset, and until considerable experience is gained, we believe that such credit should be used exclusively for financing new capital formation, although, as we have noted above, capital in well-managed businesses pays for itself not just once, but over and over again in cycles, its productiveness being renewed by reserves set aside for depreciation, before net income is computed. It is our belief that the immediate reduction in monetized welfare caused by the payment of unemployment compensation, pumping government funds into the support of boondoggle jobs, the distribution of food stamps, and the providing of welfare in general, will, under proper financial surveillance, more than offset the increase in the money supply resulting from the monetization of self-liquidating newly formed capital.

(2) Billions upon billions of dollars, actually constituting monetized welfare, are spent by the Federal government and, through "matching participation" by state and local governments, in the support of wholly synthetic jobs pursuant to the present National Economic Policy of attempting to solve the income distribution problem solely through full employment. As we begin to accelerate economic growth by making feasible the construction of the enormous quantity of new capital formation that must take place to maintain the American economy as the world's leading economy, and to eliminate poverty, need and want, this too will result in a reduction of the present monetization of welfare (concealed as employment) to further offset the temporary growth in the money supply resulting from monetizing newly formed capital. The end result, we estimate, would be no net increase in the money supply, unless, in the judgment of the Federal Reserve Board of Governors, such increase is necessary for reasons independent of an accelerating economic growth rate.

(3) Since the credit used to finance self-liquidating newly formed capital normally will be reversed within the short period of years contemplated by the feasibility study which precedes each increase in new capital formation, and since the capital instruments will continue virtually indefinitely to produce goods and services for the economy after the credit is totally reversed, their productiveness being restored by depreciation funds set aside out of gross income before net income is computed, the overall effect of the sustained new economic policy must inevitably be deflationary.

You have said, "The direct discounting of ESOP notes with the Federal Reserve Bank should be strictly limited to basic financing of high priority, self-liquidating new capital formation." Doesn't this place a large responsibility and increased degree of control by the Government in judging what constitutes "high priority" items?

Response. (1) The simple facts of life are that under our present money and banking system, there is "credit allocation." As we have shown, most credit is allocated in such manner as to make the rich richer, and to perpetuate the capital-lessness of the majority of consumer units. We are only suggesting that these priorities are the wrong priorities, and that the techniques are basically the wrong techniques. Abraham Lincoln once remarked that it is the function of government to do for the people what they cannot do for themselves. Since pure credit, by its very nature, is a "social" thing, it is, in our opinion, a necessary and proper function of government to determine the overall priorities relating to its use. It is elementary that where pure credit is used to build economic productive power into consumers, a more wholesome result is achieved than by trying to give consumers with inadequate incomes consumer credit in order to enable them to buy the goods and services they want and need, but cannot afford. Consumer credit only diminishes their consuming power—their actual power to enjoy goods and services. The interest they pay provides no enjoyment whatsoever, except to the receivers of interest.

(2) We believe that the way to get government out of the lives of most citizens is for it to forthrightly assume the responsibility for an economic policy that will enable people to individually produce high standards of living, each for himself. This diminishes the need for welfare, for governmental health care, for governmental subsidies for education, for governmental subsidies to business, for governmental imposition of higher and higher taxes to support income redistribution and boondoggle. The net effect of the transition from a one-factor economic policy to an effective two-factor economic policy should be to eliminate most of the role of government in the private lives of its citizens, yet to keep government in the position of doing for citizens that which they cannot do for themselves.

You have claimed that interest rates, reflecting only administrative and risk-costs would fall to 2–3%. What about inflationary premiums? Do you envision absolutely no increase in prices under your plan?

Response. (1) Our thinking on this subject begins with the basic proposition, that under conditions of redundancy of labor (and these have prevailed during the last three-quarters of a century, except during wars and immediately following wars), it is fundamentally dishonest for people to demand progressively more pay for progressively less work input. The principle of distribution of a communist economy is "from each according to his ability, to each according to his need." The principle of distribution in a private property, free market economy is "from each according to what he produces, to each according to what he produces." Communist economies, with their principle of distribution based on need and the government the only possible arbiter of "need," lead to totalitarian societies. Private property, free market economies, in which the government economic policy is such that every consumer unit is enabled to produce a high level of income, and therefore enjoy automatically a decent level of consumption, are free economies, because the proper economic foundation supports the structure of political democracy. We believe that it is distasteful to working people to demand progressively more pay for progressively less work input, and that they do so only because, under our defective economic policy today, they have no choice. In the mid-Thirties, because we saw no alternative solution to the problem of raising consumer incomes to where employees could afford a decent standard of living, we passed a series of laws granting to organized labor the power to use physical coercion—in reality raw, brute force—for the personal gain of the individuals involved. Rule by law and rule by brute force are opposites. One is the characteristic of a government of laws, the other is a characteristic of an anarchy or of a totalitarian society. We have adopted and are pursuing an anarchistic economic policy. (Please see the statement by historian Arnold Toynbee attached hereto as Appendix XVI, and the article by Mr. A. H. Raskin, for many years labor editor of the New York Times, attached as Appendix X.)

(2) Clearly, this coercive power cannot, and should not, be eliminated until consumers are offered true economic opportunity to produce the level of income they wish to enjoy without such coercion. I believe this can come about only through the expansion of our existing National Economic Policy into a two-factor economic policy, and through our setting about to implement that policy in the manner contemplated in our testimony before this Committee. At this point, we believe that "inflationary premiums" will disappear, and competition will arise to drive prices down to their reasonable level. The combination of cap-

ital protecting itself against extinction by not being brought into existence except on terms where it will pay for itself, and labor, as the result of the technological shift in the burden of production off labor and onto capital, being forced to demand progressively more pay for progressively less work, is the real engine of inflation. We urge Congress to remodel this engine and give national guidance to the citizens of the country in order that they may stop engaging in inflationary activities (because they are no longer necessary, and, indeed because they are now self-defeating), and we will reverse inflation and substitute for it long, gentle deflation.

(3) There is yet one other aspect of the power of government, using the tools implicit in a two-factor economic policy, to assure that "inflationary premiums" cannot be demanded by anyone. This is a renovation of our anti-trust policy in conformity with achieving the goals of a two-factor economy. Some of the steps that Congress and the Administration could take in this direction are:

(*a*) Recognize that the most dangerous monopoly in a private property, free market economy is the monopolization of the personal (family) power to produce wealth in excess of the individual's or family's desire to consume. The structural changes in financing that we have recommended will go far in correcting this evil, but Congress should study and seek other possible corrective measures.

(*b*) Where corporations are required to divest themselves because of "market monopolies" under existing anti-trust laws, in the course of accomplishing such divestitures every effort should be made to broaden the proprietary base and to build capital ownership into consumers who do not now own capital. Perhaps, through amendment of the anti-trust laws, more severe definitions of the percentage of market held by the top producers (the number would undoubtedly vary from industry to industry) should be adopted as a definition of the existence of market monopoly power.

(*c*) Since it is the inability to finance the entry of a new competitor into monopolistic or oligopolistic markets that preserves the power to administer prices and represses competition, government should make pure credit accessible to establish new companies in a monopolized or oligopolized field, making certain that such financing uses ESOP techniques or other techniques built upon two-factor principles, in order to broaden the proprietary base and widen the opportunities of all consumer units to participate in production through capital ownership. This was in essence what the U.S. government did during World War II, to bring into existence more shipbuilders, more aluminum manufacturers, etc. But in those cases, no steps were taken to assure that the ownership of the new industries would not become highly concentrated in the pinnacle capital ownership class. Similarly, the government of Japan made pure credit accessible before and after World War II in order to increase the industrial power of that nation. But again, lacking an awareness of two-factor economics, the credit was used in such manner as to incredibly concentrate the ownership of wealth in that economy.

(*d*) Keep in mind that approximately 98% of new capital formation in the past 15 years has been financed out of internal cash flow or borrowings repaid from internal cash flow, resulting in simply making the rich richer and keeping the poor capital-less. Present monopolistic power and size is inevitably the result, primarily, of defective financing techniques, and of failing to invest the corporate shareowner with private property in his equity capital, so that the wages of capital would be paid out fully and regularly, like the wages of labor. Obviously, this was not possible until alternative methods of financing growth were advanced. But we believe that the financing techniques which we have defined, and many additional ones that can be developed using the same principles, provide that alternative. In the tools constructed upon the principles of two-factor economics, government has, and should exercise, the power to prevent either business or labor from exacting "inflationary premiums" from the consumers.

THE CONCEPT OF TWO-FACTOR ECONOMICS IS A POWERFUL GOVERNMENTAL TOOL TO GUIDE ECONOMIC PLANNING, TO ACHIEVE ECONOMIC GROWTH, ECONOMIC STABILIZATION, REDUCTION OF INTEREST RATES, AND THE BUILDING OF MARKET POWER INTO THE FINANCIALLY UNDERPOWERED MAJORITY OF CONSUMERS

Congress and the Administration need new and powerful tools to solve the twin problems of inflation and unemployment, and to attain a growth rate that will eliminate the cause of poverty within a few years.

Fast and effective solutions are needed to:

Resume and accelerate economic growth. The American economy derives its strength from its ability to bring into existence powerful capital instruments—the real source of its productive power and affluence—and to match them with skilled and motivated workers. We should never forget that economic strength depends on the ability to produce an abuandance of low-cost, high-quality goods and services, and to build market power into consumers in the process. Rapid economic growth is essential if we are to achieve self-sufficiency in energy within less than a decade; if we are to rehabilitate our railroad systems; if we are to rehabilitate our cities; achieve vastly expanded production of food and fiber at much lower costs in order to meet our share of the export demand and to maintain a favorable balance of payments; build within the next decade a hundred or more new towns and a hundred or more rapid transit systems; and expand the production of basic goods and services in general.

Create several million new jobs in the private sector in the course of expanding its output of goods and services. Certainly no one can suggest that we should find make-work employment in the public sector if, in fact, the expanding private sector requires more jobs.

Protect the quality of our environment as we grow, which will further increase the need for new capital formation and for financing it.

Achieve higher incomes for our poor and our middle classes, but by means other than increases in wages and salaries, in order to avoid increasing the costs of goods and services.

Reverse inflation and achieve a gradual and continuous hardening of our money.

What can accomplish these objectives when so many other plans have failed?

Modern inflation is of such nature that it can only be eliminated by radically increased investment in self-liquidating new capital formation. It is nothing short of a miraculous coincidence that we are facing a decade in which capital formation requirements exceed by several magnitudes those of any past decade.

Not only is it true that we can and must invest our way out of inflation, while solving the other problems noted above, but credit for doing so at low interest rates is, through our deliberate use of the economic tools given to us by two-factor economics, unlimited.

Expenditures during the coming decade of upwards of $4.5 trillion on basic private-sector new capital formation, if structured to radically broaden corporate equity ownership and to minimize making the rich any richer, will reverse inflation, build market power into most consumers, create two or three generations of intense full employment, and shrink to a fraction of their present size the various government agencies devoted to attacking the effects of poverty while leaving its causes untouched. This program is an attack on the cause of poverty, namely, the low economic productiveness of the individual who does not own significant income-producing capital in a highly-industrialized economy in which the bulk of productive input is capital input. It will cause taxpayers' incomes to rise, the purchasing power of their money to grow, and their taxes to fall well below present levels.

APPENDIX I

[From the Congressional Record, Jan. 14, 1975]

INTRODUCTION OF THE ACCELERATED CAPITAL FORMATION ACT OF 1975

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Minnesota (Mr. FRENZEL) is recognized for 30 minutes.

Mr. FRENZEL. Mr. Speaker, I rise today to introduce the Accelerated Capital Formation Act of 1975. This is a refined version of H.R. 8590 which I introduced in the 93d Congress.

During the last session a great deal of progress in advancing the financing method known as ESOP or the employee stock ownership plan was made. A provision for study of the ESOP plan in restructuring the Penn Central and other Northeast and Midwest railroads was included as a vital section of the Railroad Reorganization Act. In the Pension Reform Act, signed into law last Labor Day, the ESOP was given special recognition as a form of employee benefit that could also be used to attract outside financing to meet the capital requirements of an expanding enterprise. In the Trade Reform Act companies utilizing ESOP will be given special preferences in the $1 billion program of federally guaranteed loans to companies expanding or locating in areas adversely affected by foreign competition. There were at least three other major pieces of legislation being

considered in the 93d Congress which, though they did not reach the floor, contained ESOP provisions; these were railroad improvement loans, energy development and the Pan Am Assistance Act.

Though a great deal of progress has been made in recent years many people have questioned just what an ESOP does. Essentially, under existing law, the ESOP makes accessible to all corporate employees the techniques of corporate finance. Without any actual cash outlay from corporate employees—as in conventional employee stock purchase programs—and without any deduction in take-home pay or fringe benefits an ESOP builds blocks of corporate shares into employee ownership while providing moneys necessary for capital requirements. It has been used to finance corporate expansion, acquire new assets, accomplish divestitures or spinoffs and finance mergers, et cetera.

A standard ESOP incorporates a deferred compensation trust—technically a qualified stock bonus trust alone or coupled with a money purchase pension trust—into the financing process itself. In one common technique the employees trust borrows funds to invest in the employer corporation. This then allows the affected employees, subject only to the trusts paying off the loan, to become beneficial owners of the companies' stock.

The employer corporation obligates itself to make annual payments into the trust in amounts sufficient to amortize the debt out of tax deductible dollars.

The tax deduction makes it possible for the corporation to build greater capital ownership into the employees than it could otherwise, and the costs of financing its growth is about the same as if it conveniently borrowed and repaid—as to principal—in after-tax dollars. After the employers stock has been paid for in this manner the trust can, if desired, be diversified by tax-free exchanges of stock for other securities, or by a public offering out of trust.

This ESOP method, simply stated, allows greater benefits to the corporation than common expansion and financing techniques and permits the employee to gain a larger share of the organization he serves than conventional profit-sharing methods.

The first known uses of ESOP financing, pioneered by Louis Kelso, involved an employee buy-out of a chain of California newspapers that was threatened with takeover by a major chain in 1956. But only in the last few years has the business world at large become aware of this innovation. A number of investment banking firms are pioneering this approach and several major firms have begun to recommend ESOP's to their clients. Over 100 corporations have, largely in the last year, adopted ESOP's including two of our larger electronic manufacturers. Many smaller firms and several major unions have adopted ESOP's.

In order to facilitate the use of the ESOP technique, and thus effectively link daily employee performance with the growth and operation of a business, the bill modifies the Internal Revenue Code as follows:

First, the bill removes the present statutory limitation of 25 percent of covered compensation as the maximum amount an employer can contribute to a qualified employee stock ownership plan when such payments are used to enable the plan to repay stock acquisition debt incurred in connection with meeting the employer's capital requirements. This places the sole limitation on financing contributions on the enterprise's capacity to service the debt out of cash flow. This reform reduces the cost of capital growth and transfers in the ownership of corporate assets, while accelerating the rate at which employees as individuals and as a group can accumulate stock of their employer and other income-yielding assets as a new and noninflationary form of employee benefit. Although treated as a tax deduction, this change would have the same impact as an investment tax credit in terms of encouraging capital spending; however, the investment tax credit increases the concentration of corporate ownership while ESOP contributions correct this economic factor.

This also rechannels corporate profits that would otherwise have gone into the corporate income tax base into productivity increases of the private sector, thus generating lower prices for consumers, expanded private payrolls, and a broadening base of taxable personal incomes and personal estates among productive workers.

Second, the bill provides a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust. This provision also converts taxable corporate income into either taxable dividend incomes for employees to supplement their paychecks or their retirement and social security incomes or a more rapid rate of

accumulation by employees of individual capital estates for their retirement security.

Third, the bill provides that a qualified employee stock ownership plan and trust shall have the tax characteristics of a charitable organization for purposes of estate, gift, and income taxes. This would encourage affluent taxpayers to make gifts to qualified trusts in order to reconnect the ownership of capital with a broader base of privae individuals, namely productive employees some of whom have contributed to the building of the donor's wealth. Allocations to participants of the trust would become an immediate source of taxable second incomes—to the extent dividends are passed through the trusts—and a retirement estate for the employee-beneficiaries and their heirs. On the other hand, Government would lose no tax revenues since such contributions made to charitable organizations are already exempt from taxation, and profits from donated income-producing property are frequently accumulated tax-free within such organizations.

Fourth, the bill establishes a cutoff on further contributions in behalf of any employee when the value of the assets that employee has acquired during his working lifetime through one or more ESOP's exceeds $500,000. Such a safeguard on excessive accumulations acquired through tax deductions would be especially important in highly capital-intensive industries and would help foster more widespread and equitable sharing of ownership among Americans generally.

Fifth, the bill adds to the options of ESOP participants when distributions are made when they retire, die, or are otherwise separated from service. Although profit sharing plans are permitted to make distributions in many forms, the Internal Revenue Service has ruled that distribution from an ESOP must be made exclusively in company stock.

Although enabling employees to accumulate sizable holdings of employer stock has obvious motivational value, when an employee leaves the company and can no longer directly influence the yield on the company stock accumulated in his ESOP account, it is desirable to provide the departing employee and the remaining employees, through their ESOP, to arrange an exchange for his accumulated assets with other income-yielding assets or cash of an equivalent value. This bill would provide ESOP's the same flexibility in making distributions that is now enjoyed by profit sharing plans.

Sixth, the bill permits a repurchase option for plans of enterprises that are wholly owned by their employees, so that stock of departing employees can remain exclusively held within the employee group.

Seventh, the bill exempts lump sum distributions of income-yielding estates derived from an ESOP from any form of taxation, provided the assets are held to produce a taxable second income for the taxpayer or his beneficiaries. However, if the assets are converted into spendable income and not reinvested within 60 days, the uninvested proceeds will be taxed as ordinary income, instead of partially at the lower capital gains rate permitted under present law.

Eighth, the bill enables affected parties to seek advance IRS opinions on valuations on stock or other assets acquired by an ESOP where the parties to a financing transaction which utilizes the ESOP would be subject to serious risks or penalties if the IRS, upon subsequent audit, disagreed with the valuations or other key features of the financing plan. This is similar to the "no action" procedures already instituted by the FTC and SEC.

Ninth, the bill exempts payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the Federal or State levels. Instead, it would be treated as any other form of capital spending that would have a counterinflationary effect. In effect, it offers labor a trade-off for wage increases where wage ceilings are established.

I hope that the members of this body will carefully consider the legislation. I am hopeful that further progress can be made in this session.

A copy of the bill follows:

H.R. ——

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TITLE.—This Act may be cited as the "Accelerated Capital Formation Act of 1975."

SEC. 2. PURPOSE.—The purpose of this Act is to provide incentives for accelerated financing of the formation of U.S. corporate capital and to encourage voluntary means for broadly diffusing equity ownership among employees of U.S. enterprises both (a) with respect to existing capital by means consistent with the protection of private property and (b) with respect to newly formed capital by means which extend the logic of conventional business finance to corporate employees.

SEC. 3. AMENDMENT OF INTERNAL REVENUE CODE.—The Internal Revenue Code of 1954 is amended by adding the following new Section 416 at the end of Subpart B of Part I of Subchapter D of Chapter 1:

SEC. 416.—EMPLOYEE STOCK OWNERSHIP PLAN FINANCING

(a) DEFINITIONS. (1) "Employee stock ownership plans" means a technique of corporate finance described in Section 4975(e)(7) that utilizes stock bonus plans, or stock bonus plans coupled with money purchase pension plans, which satisfy the requirements of Section 401(a) and are designed—

(A) to invest primarily in qualifying employer securities;

(B) to meet general financing requirements of a corporation, including capital growth and transfers in the ownership of corporate stock;

(C) to built into employees beneficial ownership of qualifying employer securities;

(D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans and credit secured primarily by a commitment by the employer to make future payments to the plan in amounts sufficient to enable such loans and interest thereon to be repaid; and

(E) to limit the liability of the plan for repayment of any such loan to payments received from the employer and to qualifying employer securities, and dividends thereon, acquired with the proceeds of such loan, to the extent such loan is not yet repaid.

(2) For purposes of this section, the term "employer securities" means securities issued by the employer corporation, or by an affiliate of such employer.

(3) For purposes of this section, the term "qualifying employer securities" means common stock, or securities convertible into common stock, issued by the employer corporation, or by an affiliate of such employer.

(b) Special Deductions. (1) In addition to the deductions provided under section 404(a), there shall be allowed as a deduction to an employer the amount of any dividend paid by such employer during the taxable year with respect to employer securities, provided—.

(A) such employer securities were held on the record date for such dividend by an employee stock ownership plan; and

(B) the dividend received by such plan is distributed, not later than 60 days after the close of the plan year in which it is received, to the employees participating in the plan, in accordance with the plan provisions; or

(C) the dividend received by such plan is applied, not later than 60 days after the close of the taxable year, to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(2) Notwithstanding the limitations of section 404(a), there shall be allowed as a deduction to an employer the amount of any contributions paid on account of a taxable years (as described in section 404(a)(6)) to an employee stock ownership plan, provided such contributions are applied to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(3) For purposes of sections 170(b)(1), 642(c), 2055(a), and 2522, a contribution, bequest, or similar transfer of employer securities or other property to an employee stock ownership plan shall be deemed a charitable contribution to an organization described in section 170(b)(1)(A)(vi), provided—

(A) such contribution, bequest, or transfer is allocated, pursuant to the terms of such plan, to the employees participating under the plan in a manner consistent with section 401(a)(4);

(B) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent), or any person related to the taxpayer (or decedent) under the provisions of Section 267(b), or any other person who owns more than 25% in value of any class of outstanding employer securities under the provisions of Section 318(a); and

(C) such contribution, bequest or transfer is made only with the express approval of such employee stock ownership plan.

(c) *Treatment of Participants.* (1) Qualifying employer securities acquired by an employee stock ownership plan through acquisition indebtedness incurred by the plan in connection with the financing of capital requirements of the employer corporation or its affiliates must be allocated to the accounts of the participating employees to the extent that contributions and dividends received by the plan are applied to the payment of such acquisition indebtedness (including intest), in accordance with the terms of the plan and in a manner consistent with Section 401(a)(4).

(2) Upon retirement, death or other spearation from service, an employee participating under an employee stock ownership plan (or his beneficiary, in the event of death) will be entitled to a distribution of this non-forfeitable interest under the plan in employer securities or other investments allocated to his account, in accordance with the provisions of such plan. If the plan so provides, the employee (or beneficiary) may elect to receive all or a portion of the distribution from the plan in—

(A) employer securities, other than qualifying employer securities;
(B) cash;
(C) a diversified portfolio of securities;
(D) a non-transferable annuity contract; or
(E) any combination of the above.

(3) An employee stock ownership plan may provide for the required repurchase of qualifying employer securities from an individual receiving a distribution thereof if all other of such outstanding employer securities, whether or not acquired through the plan, are subject to repurchase from non-employee shareholders under similar circumstances.

(4) Upon receipt of a lump sum distribution, as described in Section 402(e)(4)(A), from an employee stock ownership plan, an individual may exclude from gross income that part of the distribution which consists of employer securities or other assets, if income producing, held or reinvested within 60 days in income producing assets of equivalent value, for the purpose of providing the individual with dividends or other forms of realized income from such assets. Upon subsequent sale or disposition of any employer securities or other assets distributed by an employee stock ownership plan to the extent that proceeds realized from such sale or disposition are not reinvested within 60 days in income producing assets, the total amount of such proceeds (or the fair market value of any such securities or assets that are transferred without adequate consideration) shall be treated as ordinary income to the individual.

(5) An employee receiving a distribution under paragraph (b)(1)(B) of this Section shall be subject to taxation under Section 402(a)(1), and the provisions of Section 116 shall not apply to such distribution.

(6) A contribution by an employer which is deductible under paragraph (b)(2) of this Section, or a contribution described in paragraph (b)(3) of this Section, shall not be included in the meaning of annual addition under Section 415(c)(2).

(7) No contribution to an employee stock ownership plan may be allocated for the benefit of any participant if the value of the total accumulation of employer securities and other investments under the plan for the benefit of that participant equals or exceeds $500,000, less the amount of any such accumulation for that participant under any other employee stock ownership plans.

(d) *Special Provisions.* (1) The acquisition or holding of qualifying employer securities and the incurring of acquisition indebtedness by an employee stock ownership plan shall be deemed to satisfy the requirements of Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 provided that—

(A) the requirements of Section 408(b)(3) and 408(e) of such Act are satisfied; and

(B) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

(2) Upon application by an employee stock ownership plan, the Secretary of the Treasury or his delegate shall issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraph (1) of this subsection, and any such opinion shall be binding upon the Secretary.

SEC. 4.—*Effect of Economic Stabilization.*—Payments by an employer to an employee stock ownership plan as defined in Section 416(a)(1) of the Internal Revenue Code of 1954, for the purpose of enabling such plan to pay acquisition indebtedness incurred for the purchase of qualifying employer securities or other contributions to such plan shall not be treated as compensation, fringe benefits or deferred compensation payments for the purposes of any laws, executive orders or regulations designed to control, establish guidelines or otherwise stabilize employee compensation or benefits, but shall be treated as the equivalent of debt service payments made in the normal course of financing the capital requirements of that employer.

APPENDIX II

PROPOSED AMENDMENTS TO INTERNAL REVENUE CODE RELATING TO DEDUCTIONS FOR ESOP CONTRIBUTIONS

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (10) to subsection (a) of Section 404 of Subpart A of Part I of Subchapter D of Chapter 1:

"(10) *Employee stock ownership plans.*—In the case of an employee stock ownership plan described in Section 4975(e)(7), notwithstanding the provisions of paragraphs (1), (3) and (7), there shall be allowed as a deduction the amount of any contributions paid to the plan on account of a taxable year, as described in paragraph (6), provided such contributions are applied by the plan to the repayment of acquisition indebtedness (including interest) incurred for the purchase of qualifying employer securities."

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (5) to subsection (c) of Section 415 of Subpart A of Part I of Subchapter D of Chapter 1:

"(5) *Employee stock ownership plans.*—Employer contributions described in Section 404(a)(10), and any forfeitures attributable thereto, shall not be included in the meaning of annual addition under paragraph (2), so long as the employee stock ownership plan provides that no contribution (or forfeitures) may be allocated to the accounts of any participant if the total value (as of the close of the plan year) of the qualifying employer securities and other investments accumulated under the plan for his benefit equals or exceeds $500,000, less the amount of any such accumulation for that participant under any other employee stock ownership plan described in Section 4975(e)(7)."

APPENDIX III

PROPOSED AMENDMENT TO INTERNAL REVENUE CODE RELATING TO DONATIVE TRANSFERS TO AN ESOP

The Internal Revenue Code of 1954 is hereby amended by adding the following new subparagraph (G) at the end of paragraph (1) of Section 170(b) of Part VI of Subchapter B of Chapter 1:

"(G) *Certain transfers to an employee stock ownership plan.*—For purposes of paragraph (a)(1) and of this paragraph, and for purposes of Sections 642(c)(1), 2055(a) and 2522, a contribution, bequest or similar transfer of qualifying employer securities or other property to an employee stock ownership plan, as described in Section 4975(e)(7), shall be deemed a charitable contribution to an organization described in subparagraph (A)(vi), provided—

"(i) such contribution, bequest or transfer is allocated, pursuant to the terms of such plan, to the employees (or former employees or their beneficiaries) participating under the plan, in a manner consistent with Section 401(a)(4);

"(ii) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent), or any person related to the taxpayer (or decedent) under the provisions of Section 267(b), or any other person who owns more than 25% of any class of outstanding qualifying employer securities, under the provisions of Section 318(a);

"(iii) such contribution, bequest or transfer is made only in accordance with the express provisions of the employee stock ownership plan; and

"(iv) such contribution, bequest or transfer is treated as an employer contribution to the plan for purposes of Sections 402 and 411, but not for purposes of Sections 404 and 415."

Appendix IV

Proposed Amendment to Internal Revenue Code To Permit Corporate Tax Deduction for Dividends Paid on Employer Stock in Connection With an ESOP

The Internal Revenue Code of 1954 is hereby amended by adding the following new Section 251 at the end of Part VIII of Subchapter B of Chapter 1:

"SEC. 251—DIVIDENDS PAID IN CONNECTION WITH AN EMPLOYEE STOCK OWNERSHIP PLAN

"(a) *Deduction allowed.*—In the case of a corporation maintaining an employee stock ownership plan, as defined in Section 4975(e)(7), there shall be allowed as a deduction the amount of any dividends paid during the taxable year with respect to qualifying employer securities, as defined in Section 4975(e)(8), provided—

"(1) such qualifying employer securities were held on the record date for such dividend by the employee stock ownership plan or by an individual holding qualifying employer securities distributed to him from the employee stock ownership plan; and

"(2) any dividend received by such employee stock ownership plan is distributed, not later than sixty (60) days after the close of the plan year in which it is received, to the employees, former employees and their beneficiaries having accounts under the employee stock ownership plan, in accordance with the provisions of such plan; or

"(3) any dividend received by the employee stock ownership plan is applied, not later than sixty (60) days after the close of the plan year, to the repayment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities."

Appendix V

Proposed Amendment to Internal Revenue Code Relating to ESOP Allocations and Distributions

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (20) to subsection (a) of Section 401 of Subpart A of Part I of Subchapter D of Chapter 1:

"(20) A trust forming part of an employee stock ownership plan, as defined in Section 4975(e)(7), shall not constitute a qualified trust under this Section unless the provisions of the plan satisfy the requirements of this paragraph.

"(A) Qualifying employer securities acquired by the plan through acquisition indebtedness incurred by the plan, in connection with the financing of capital requirements of the employer corporation (or its affiliates), shall be allocated annually among the accounts of the participants to the extent that contributions by the employer (and dividends received by the plan on qualifying employer securities) are applied to the repayment of such acquisition indebtedness (including interest), in accordance with the provisions of the plan and substantially in proportion to their relative compensation. The allocation for each plan year shall represent that portion of qualifying employer securities acquired with the proceeds of any loan the cost of which bears substantially the same ratio to the cost of all qualifying employer securities acquired with the proceeds of that loan as the amount of loan principal and interest repaid by the plan for that plan year bears to the total amount of principal and interest payable by the plan during the term of such loan.

"(B) Upon retirement or death, or following separation from service, an employee participating under the plan (or his beneficiary, in the event of his death) is entitled to a distribution of his nonforfeitable interest under the plan in the employer securities or other investments allocated to his accounts, in accordance with the provisions of the plan. If the plan so provides, the participant (or beneficiary) may elect (prior to or following separation from service) to receive all or a portion of his distribution from the plan in—

"(i) other employer securities;

"(ii) cash;

"(iii) a diversified portfolio of income producing assets;
"(iv) a nontransferable annuity contract; or
"(v) any combination of the above.
"(C) An employee stock ownership plan may provide for the mandatory repurchase of employer securities from an individual receiving a distribution thereof if all other outstanding employer securities of the same class, whether or not acquired under the plan, are subject to mandatory repurchase from none-employee shareholders under similar circumstances."

APPENDIX VI

PROPOSED AMENDMENT TO INTERNAL REVENUE CODE RELATING TO DEFERRAL OF TAXATION ON ESOP DISTRIBUTIONS

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (5) to subsection (e) of Section 402 of Subpart A of Part I of Subchapter D of Chapter I:

"(5) *Employee stock ownership plans*—

"(A) Upon the receipt of a lump sum distribution from an employee stock ownership plan, as defined in Section 4975(e)(7), an individual may exclude from gross income that portion of the distribution which is held by him in the form of employer securities or is transferred to, and held or reinvested within sixty (60) days in, an individual stock ownership plan described in subparagraph (C) of this paragraph, as a rollover contribution described in subsection (a)(5), for the purpose of providing that individual with dividends on such employer securities or other forms of realized current income from income producing assets held in such individual stock ownership plan.

"(B) Upon subsequent sale or disposition of any such employer securities (except upon death), or distribution of any such assets from the individual stock ownership plan, to the extent that the proceeds realized from such sale, disposition or distribution are not exchanged for other employer securities, or reinvested within sixty (60) days in income producing assets under an individual stock ownership plan, the total amount of such proceeds (or the fair market value of any property transferred without adequate consideration) shall be treated as ordinary income to that individual."

"(C) Individual Stock Ownership Plan—An individual stock ownership plan which is established to receive proceeds distributed from an employee stock ownership plan, as described in this paragraph, shall be an individual retirement account, under Section 408(a), in all respects, except that—

"(i) the requirements of paragraphs (6) and (7) of Section 408(a) shall not be applicable;

"(ii) the taxes provided in Sections 408(f) and 4974 shall not be applicable;

"(iii) the total realized current income (excluding gains on the sale of the plan must be distributed, not later than sixty (60) days following the close of the taxable year in which such income is received by the plan, to that individual for whose benefit the plan is maintained; and

"(iv) the plan may only hold amounts which are attributable to distributions from an employee stock ownership plan."

APPENDIX VII

PROPOSED AMENDMENT TO INTERNAL REVENUE CODE RELATING TO IRS "NO-ACTION" PROCEDURE FOR ESOP TRANSACTIONS

The Internal Revenue Code of 1954 is hereby amended by adding the following new paragraph (7) at the end of subsection (f) of Section 4975 of Chapter 43:

"(7) *Procedure for advance opinions with respect to employee stock ownership plan.*—Upon application by an employee stock ownership plan, as defined in subsection (e)(7), the Secretary or his delegate shall, within sixty (60) days, issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraphs (3) and (13) of subsection (d). Such opinion shall be binding upon the Secretary, and shall be deemed to be a determination with respect to qualification for purposes of Section 7476(a), relating to certain declaratory judg-

ments of the Tax Court, except that administrative remedies shall be deemed to have been exhausted after sixty (60) days following application by the plan. The Secretary or his delegate shall, within ninety (90) days following the enactment of this paragraph, promulgate regulations and guidelines for the implementation of the procedure described in this paragraph."

APPENDIX VIII

PROPOSED AMENDMENT TO ERISA CLARIFYING FIDUCIARY DUTIES APPLICABLE TO ESOP TRANSACTIONS

The Employee Retirement Income Security Act of 1974 is hereby amended by adding the following new subsection (d) to Section 404 of Part 4 of Subtitle B of Title I:

"(d) In the case of an employee stock ownership plan, as defined in Section 407(d)(6), the acquisition or holding of qualifying employer securities, or the incurring of acquisition indebtedness for the purchase thereof, shall satisfy the requirements of paragraph (a)(1), provided—

"(1) the requirements of subsections (b)(3) and (e) of Section 408 are satisfied with respect to any transaction between the plan and a party in interest and

"(2) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied."

APPENDIX IX

PROPOSED AMENDMENTS TO INTERNAL REVENUE CODE RELATING TO DEFINITION OF ESOP

The Internal Revenue Code of 1954 is hereby amended by restating paragraph (7) of subsection (e) of Section 4975 of Chapter 43 to read as follows:

"(7) *Employee stock ownership plan.*—The term "employee stock ownership plan" satisfies the requirements of Section 401(a) and is designed—

"(A) to invest primarily in qualifying employer securities;

"(B) to meet general capital financing requirements of a corporation, including capital growth and transfers in the ownership of qualifying employer securities;

"(C) to build into employees beneficial ownership of qualifying employer securities, substantially in proportion to their relative compensation;

"(D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans or credit secured primarily by a commitment by the employer to make future payments to the plan (which may include dividends on qualifying employer securities) in amounts sufficient to enable such loans (and interest thereon) to be repaid; and

"(E) to limit the liability of the plan (and its participants) for repayment of any such loan (including interest) to payments received from the employer (which may include dividends on qualifying employer securities) and to that portion of the qualifying employer securities acquired with the proceeds of such loan which represents that portion of the loan principal remaining unpaid."

The Secretary or his delegate may prescribe regulations further defining "employee stock ownership plan" consistent with the provisions of this paragraph. An employee stock ownership plan which satisfies the requirements of this paragraph shall also satisfy the definitions under Section 301(d)(2) of the Tax Reduction Act of 1975 and Section 407(d)(6) of the Employee Retirement Income Security Act of 1974.

The Internal Revenue Code of 1954 is hereby amended by inserting the following new subparagraph (C) after subparagraph (B) in paragraph (8) of subsection (e) of Section 4975 of Chapter 43:

"(C) For purposes of an employee stock ownership plan, as defined in paragraph (7), qualifying employer security means an employer security which is common stock or preferred stock convertible (at a reasonable conversion ratio) into common stock."

APPENDIX X

[From the New York Times, Monday, Sept. 1, 1975]

FOR ORGANIZED LABOR, WHAT REPLACES 'MORE'?

(By A. H. Raskin)

Nearly a century ago Samuel Gompers summed up the goals of the American labor movement in the single word "more." Asked what labor would want after it got "more," his answer was "more and more."

Few forecasts, especially in the murky realm of economics, have stood history's test as well as that laconic response by the founder of the American Federation of Labor. Unions have grown vastly in size, scope and power, especially in the four decades since Franklin D. Roosevelt's New Deal.

Their collective bargaining agreements now cover so many items that some exceed telephone directories in thickness. Union leaders walk with assurance through the White House and the halls of Congress; they push around governors and mayors; they move on terms of easy familiarity among corporate executives and bankers (and even, in many cases, among their own rank and file).

The faces at the top change, though usually with glacial slowness, but the Gompers credo has come essentially unchanged through such dissimilar latter-day types as John L. Lewis and Walter P. Reuther and James R. Hoffa to remain unionism's central objective in the never-ending reign of George Meany. In Hoffa's words, "What's it all about if not to bring back the highest buck for our people?"

But this Labor Day, for the first time, some leaders steeped in the practices of bread-and-butter unionism are finding the answer to that rhetorical query not at all self-evident. On the contrary, the dismal experience a few unions have had recently of negotiating down, not up, under the pressure of pinched municipal budgets or the deadening effect of low-wage imports on their industries makes them feel that the answer may be almost as much a mystery as whether Jimmy Hoffa himself is alive or dead.

For unionists in this class, the pivotal question is one almost no one in labor's top echelon likes even to think about: What can a labor movement built on "more" find as a substitute reason for being if the recession-tightened squeeze now afflicting particular fields proves the forerunner a few years hence of a lasting slowdown—perhaps even a dead stop—in the exuberantly expanding economy that made the Gompers doctrine work?

The problem is already here for New York City's civil service unions, fastest runners in the race for wages and benefits through all of the last decade, now in the unhappy position of having to give back some of what they got and facing a three-year freeze on getting any more.

The first impact is on the job security of the "pork-choppers"—the unions' paid leadership—especially in the police and fire unions, where militancy in delivering "more and better" has been the test of fitness to such an extent in the last three or four years that one transient officer suggested equipping the union president's office with an aircraft ejector seat.

In the case of the Uniformed Firefighters Association, a revolving door might be even more appropriate, Michael J. Maye, an ex-Golden Gloves boxing champion, was voted out as president two years ago on the ground that he had not fought hard enough for his men. In July he was voted back again, largely because his interim successor, Richard Vizzini, was rolled flat by the budget juggernaut.

"The days of great longevity among public sector union leaders are over," says Ken McFeeley, president of the Patrolmen's Benevolent Association, who got his own job a year ago by accusing his predecessors of doing too little to bolster police prestige and pay.

He predicts that there will be no more careers like that of John J. DeLury, who has been representing the city's sanitationmen since the mayoralty of Fiorello H. La Guardia. The 36-year-old Mr. McFeeley was not even born when the president of the Uniformed Sanitationmen's Association started building political fences in City Hall and Albany.

"The DeLurys could think in terms of stable relations like the Southern Democrats in Congress," the P.B.A. head notes. "The new crop all grew up in the 1960's when you threw a rock and got a bargaining concession. The turnover in union leadership is fast. You have two or three years to produce. Otherwise, somebody else has got your job."

In this twilight of "more," it is not only leaders but also unions that have to pass the "what have you done for me lately?" test. An object lesson in what can happen to those that flunk is being provided by the Civil Service Employees Association in New York State. A strong favorite of Nelson A. Rockefeller when he was Governor, it won bargaining rights in 1968 for 124,000 state employees and 90,000 others in county and local governments.

This year Governor Carey rejected a fact-finding board's recommendation that the state workers receive a 6 percent wage boost. Instead, he decreed that they be given a one-shot bonus of $250 for the year. The union decided not to strike. Now it is under two-pronged attack by rival unions seeking to capitalize on rank-and-file disaffection by swallowing up its membership.

Outside the civil service sector, the first major casualties of what may become permanent stagflation are two of the country's most respected unions—the International Ladies Garment Workers Union and the Amalgamated Clothing Workers of America, each with close to a half-million members.

Both have suffered mass layoffs and drastically shortened work-weeks, primarily as a result of imports. That has made the two unions built by immigrants in the old Lower East Side and the slums of Chicago, fiercely protectionist. It has also cut the average earnings of their members—those who still have jobs—to levels less than half those in steel and auto.

Sol C. Chaikin, the dynamic incoming president of the I.L.G.W.U., is close to despair at the plight of his people. He believes the country must start developing an incomes policy that will aim at a genuine redistribution of income, not just in the "soak the rich" terms of stavistic union oratory.

"We may have to stop giving any more money to construction, steel and auto and give it to the people at the bottom in garment, hotel and restaurant, retail trade and all the other places where people are pushing, pulling, carrying for less money than it takes to live," Mr. Chaikin says.

That is not a view likely to evoke cheers from the entrenched labor hierarchy nor will it find many echoes at the bargaining table, where unions representing almost 5 million workers will be arguing for "more" next year.

Unfortunately for workers, however, there is a squirrel-cage quality to the contract process even where the recession has brought no break in the wage climb. In the first half of 1975, for instance, first-year pay increases in all major settlements averaged 11 per cent. This was double the anti-inflation standard enforced by the old Pay Board and nearly quadruple the long-term rate of past growth in national productivity.

Yet, even with the reinforcement of cost-of-living escalators, which now cover half the unionized work force, workers have been running a losing race against inflation. The purchasing power of the average weekly pay envelope went down by 5.6 per cent in the last two years, and the loss would have been over 10 per cent without the buoying effect of the one-year cut in withholding taxes in May. Since 1970 the average worker has had a gain of 35.8 per cent in gross pages, virtually all of it rubber. After adjustment for higher prices and taxes, only about $1 of the $43.01 in nominal increases could be traded in for more meat and groceries at the supermarket.

The institutionalization of that treadmill bespeaks a broadening of labor's horizons, whether or not the pessimists are right in predicting that this country may have to adjust to a revolution of declining expectations after two bullish centuries.

In Europe, where unions never got anywhere close to American standards on the way up, the almost universal trend is toward much great worker involvement in management, everything from co-equal representation in company boardrooms to employee participation in the design of jobs.

Co-determination on the West German model, now about to become law throughout the Common Market, is still poison to American unions. But the United Auto Workers and a few others are moving forward on joint experiments with their employers in projects designed to improve the quality of working life and to increase employe satisfaction in their jobs.

Most unions scoff at such projects as boondoggles or attempts to defang labor. Indeed, the A.F.L.-C.I.O. has just succeeded in all but eliminating references to work quality from a bill the Senate is expected to pass this week establishing a new National Center for Productivity and the Quality of Working Life, with a $5 million annual budget.

But the sterility of the pursuit of "more" and the pressures for change from a changing work force are likely to make a larger voice in everything having to do with the job a big element in labor's future.

[From the New York Times, Sunday, Jan. 4, 1976]

THE WORKERS IN THE EXECUTIVE SUITE

(By A. H. Raskin)

The worker who was always sure he knew how to run the business better than the boss is more often getting a chance to prove it. And in a growing number of companies in the United States and Western Europe worker participation in responsibilities that have traditionally been the province of management appears to be paying off handsomely, for the bosses as well as their enhanced employees.

Indeed, most of the current experiments in worker involvement start not on the initiative of employees but of employers worried by high absenteesim, low productivity, slowdowns and other symptoms of poor employee morale. Many personnel officers call it "the Lordstown syndrome" in unhappy memory of a three-week wildcat strike in 1972 over what workers saw to be dehumanizing work conditions at General Motors' super-efficient new Vega assembly plant at Lordstown, Ohio.

Since Lordstown, General Motors and the United Automobile Workers, neither of which had thought very highly of job enrichment—or of the maverick worker—before have been in the vanguard of the still relatively modest movement toward greater industrial democracy in the United States. Though all this expansion in experimentation has so far affected only a limited number of the private and public work force in America, progress on both sides of the Atlantic was impressive enough last year to lead Ted Mills, director of the private, university-affiliated National Quality of Work Center in Washington to predict that the worker participation movement, will become "one of the salient social and economic phenomena of the last quarter of the 20th century."

The forms worker involvement is taking vary. But their common thread lies in the attempt to give employees a sense of direct participation in making their jobs more satisfying while maintaining necessary efficiency. Capsulizing the intricate arrangements in any successful work-quality or job enrichment endeavor rarely conveys the dimensions of either the problem or the change, both of which experts vociferously debate. But here are micro-reports on three that seem to be doing well:

At the Rushton Mining Company in central Pennsylvania autonomous work teams rotate jobs and dig coal unsupervised. The foreman puts his energies into improved safety, and the accident rate has dropped to record lows. Every miner gets top pay; yet the cost runs a third lower for the self-directed crews than for those using standard methods.

At the Harman auto mirror factory in Bolivar, Tenn., a union-management committee developed an earned idle time concept that enables workers to go home or to take adult education courses inside the plant if they complete their production quotas in less than eight hours. A sharing plan on cost savings kept the plant from closing last year when the market for auto mirrors plummeted.

In the Tennessee Valley Authority, a joint committee reorganized the work structure for 400 engineers who plan placement of transmission lines through all the giant utility's region. A new branch dealing solely with environmental affairs was set up at the group's suggestion. Management is so pleased that the job enrichment experiment will be extended this year to other authority divisions.

In Europe, many more workers have much more power (some work teams, for example, have the right to fix their own budgets and to hire or fire team members). But the shop-level aspects of work humanization abroad do not differ greatly from those in the United States.

What is different is the financing in America. Private philanthropy, notably the Ford Foundation, has been the big subsidizer of work experiments; in West Germany, France, Japan and other foreign countries most of the money has come from government.

The most fundamental difference, however, is in the European unions' concentration on winning a statutory right to majority control on corporate decision-making boards. This is a right American unions do not want any more than industry wants them to have it. Both feel it would erode what they regard to be

the proper lines between management and labor in a way detrimental to workers, owners and the free economy.

West German unions, in contrast, are well on their way toward Bundestag approval for revision of their quarter-century-old system of "codetermination" that will guarantee labor 50-50 parity with management on the supervisory boards of all major companies. Up to now the workers have had one-third representation except in coal and steel, the new plan will still leave stockholders with the power of decision if deadlocks occur.

In Sweden, officials of the Metal Workers Union want to go much further. Their aim—denounced by employers as a form of expropriation inconsistent with the spirit of Swedish labor-management cooperation—is a law requiring that all industry's "excess profits" go into a fund that would eventually be used to buy up control of major companies for the benefit of all unionized workers.

A 180-degree twist, into reverse socialism, is involved in the nearest thing to an American counterpart. It is the Employee Stock Ownership Plan put forward by Senator Russell B. Long, Louisiana Democrat, and Louis O. Kelso, a San Francisco lawyer and investment banker. Its goal is to make every worker a capitalist by facilitating employee acquisition of stock, thus turning wage-earners into shareholders who will be prompted to produce more by the hope of higher dividends. Mr. Kelso sees the plan as the key to a great capitalist renaissance, at the opposite pole from the new Swedish proposal.

Appendix XI

Legislative History on Employee Stock Ownership Plans

I. Regional Rail Reorganization Act of 1973, P.L. 93-236; signed by President on January 2, 1974. [Sections 102(5); 206(e)(3); 301(e).]

A. Bills:

S. 2767, reported from Committee on Commerce on December 3, 1973, by Senator Hartke. [Sections 103(5); 206(e)(3); and 301(e).]

H.R. 9142, reported from Conference Committee on December 20, 1973. [Sections 102(5); 206(e)(3); and 301(e).]

B. Committee reports:

House Report 93-744, Conference Report, accompanying H.R. 9142, December 20, 1973, Pages 3, 14, 22 and 46.

Senate Report 93-601, Senate Commerce Committee Report on S. 2767, December 6, 1973, Pages 20, 27, and 30.

C. Congressional Record:

December 11, 1973, Senate Floor Statements, Pages S 22527-8 (Hatfield); S 22533-4 (Javits); S 22547-52 (Long and Hartke).

December 21, 1973, Senate Floor Statements, Pages S 23784-5 (Long and Hartke).

February 26, 1975, Senate Floor Statement, Page S 2625-7 (Hatfield).

D. Hearing reports:

Hearings on S. 1031, Northeastern Railroad Transportation Crisis, Surface Transportation Subcommittee, Committee on Commerce, U.S. Senate, 93rd Congress, 1st Session, February 28, 1973, Pages 89-149 (Louis O. Kelso).

Hearings on S. 2188 and H.R. 9142, Northeastern and Midwestern Railroad Transportation Crisis, Surface Transportation Subcommittee, Committee on Commerce, U.S. Senate, 93rd Congress, 1st Session, November 16, 1973, Pages 908-11 (Norman G. Kurland).

II. Employee Retirement Income Security Act of 1974, P.L. 93-406; signed by President on September 2, 1974. [Sections 407(d)(5); 408(b)(3); and 2003 (amends Internal Revenue Code by adding new Sections 4975(d)(3) and 4975 (e)(7).]

A. Bill:

H.R. 2, reported from Conference Committee, August 12, 1974. [Same as above for P.I. 93-406.]

B. Committee reports:

House Report 93-1280, Conference Report, accompanying H.R. 2, August 12, 1974, Pages 63, 64, 65, 67, 172, 176, 191-2, 308, 312-5, and 317.

Committee Print, Summary of Differences Between the Senate Version and the House Version of H.R. 2 to Provide for Pension Reform, House and Senate Con-

ferees on H.R. 2, Part 3, Fiduciary and Enforcement, June 12, 1974, Pages 5, 7, and 8.

C. Congressional Record:

August 20, 1974, House Floor Statements, Page H 8720.

August 21, 1974, Senate Floor Statements, Page S 15734.

D. Hearing reports:

Hearings, Tax Proposals Affecting Private Pension Plans, Committee on Ways and Means, House of Representatives, 92nd Congress, 2nd Session, Part 3, May 16, 1972, Pages 647–720 (Louis O. Kelso).

Committee Print No. 1, Written Statements . . . on H.R. 10470, "Retirement Income Security for Employees Act;" Introduced on September 24, 1973 (identical to Senate Amendments to H.R. 4200, as passed by Senate on September 19, 1973), Committee on Ways and Means, U.S. House of Representatives, 93rd Congress, 1st Session, October 1, 1973, Pages 463–9 (Letter from Louis O. Kelso, dated September 28, 1973, to Chief Counsel, Ways and Means Committee).

III. Trade Act of 1974, P.L. 93–618, signed by President on January 3, 1975. [Section 273(f).]

A. Bill:

H.R. 10710, Reported by Senate Finance Committee on November 26, 1974, by Senator Long. [Sections 273(d)(2) and 273(f).]

B. Committee reports:

Senate Report 93–1298, Senate Finance Committee Report on H.R. 10710, November 26, 1974, Pages 29, 155–60.

House Report 93–1644, Conference Report, accompanying H.R. 10710, December 19, 1974, Pages 12 (Amendment to [Section 273(f)(1)] and 40, first paragraph.

Committee Print, TRADE ACT OF 1974, Summary of the Provisions of H.R. 10710, Senate Finance Committee and House Ways and Means Committee, December 30, 1974, Page 9.

C. Congressional Record:

October 3, 1974, Senate Floor Statement, Pages S 18261–2 (Senator Long).

IV. Tax Reduction Act of 1975, P.L. 94–12; signed by President on March 29, 1975. [Section 301(d); amends Paragraph (1) of Section 46(a) of the Internal Revenue Code.]

A. Bill:

H.R. 2166, reported by Senate Finance Committee on March 17, 1975 by Senator Long. [Sections 301(a)(1)(D); 301(a)(1)(E); 301(d); 304.]

H.R. 2166, as amended by the Senate, March 22, 1975 [Sections 301(a)(1)(D); 301(a)(1)(E); 301(d); and 305.]

B. Committee reports:

Senate Report 94–36, Senate Finance Committee Report on H.R. 2166, March 17, 1975, Pages 55–60.

Committee Print, Summary of the Major Provisions of Public Law 94–12, Tax Reduction Act of 1975, April 1, 1975, House Ways and Means Committee, Page 7.

C. Congressional Record:

March 18, 1975, Senate Floor Statement by Senator Long (Pages S 4223–4, S 4255); by Senator Fannin (Page S 4246).

March 20, 1975, Senate Floor Statement by Senator Fannin (Page S 4549–50).

March 20, 1975, Senator Long reported H.R. 2166 as amended by the Senate, Pages S 4489, S 4492–3.

March 26, 1975, ESOP Provisions of H.R. 2166, introduced into House by Rep. Ullman, Pages H 2358–9; Conference Report Explanation of ESOP Provisions, H 2368–9.

March 26, 1975, Senate Floor Statements, Pages S 5245 (Long); S 5263 (Senate Staff Report).

March 26, 1975, House Floor Statement by Rep. Ullman, Page H 2382.

D. Hearing reports:

Hearings, Antirecession Tax Cut, Committee on Finance, U.S. Senate, 94th Congress, 1st Session, on H.R. 2166, March 10, 1975, Pages 175–6 (Senator Humphrey); 199–200 (Charles L. Brown for ATT); 205–33 (Louis O. Kelso and Norman G. Kurland).

V. Tax policy and capital formation:

February 18, and 19, 1976, Hearings on Tax Policy and Capital Formation Financial Markets Subcommittee, Committee on Finance, United States Senate, Ninety-Fourth Congress, 2nd Session (Louis O. Kelso and Norman G. Kurland).

APPENDIX XII

[From Business Week, Mar. 1, 1976]

EMPLOYEE STOCK PLANS BEGIN TO CATCH FIRE

WHO'S USING ESOP'S, AND WHAT THE CRITICS HAVE TO SAY

For many years the idea that the U.S. could be transformed into a paradise of people's capitalism through employee ownership of stock in the companies they worked for existed in an intellectual underworld whose main figure was Louis O. Kelso, a San Francisco lawyer and self-styled economic theorist.

Now, under the impact of legislation that gives new tax breaks to companies that adopt employee stock ownership plans (ESOP's), Kelso's ideas are taking on new life. By turning every worker into a capital owner, says Kelso, "we can enhance worker productivity, raise the capital needed to accelerate economic growth and reduce unemployment, and defuse the conflict between management and labor that underlies the wage-price spiral."

Many businessmen and economists still argue that ESOPs have the potential for creating more problems than they solve. But in the past year or two such companies as Mobil Oil, Hallmark Cards, E-Systems, and Atlantic Richfield have decided to take advantage of the new legislation and give their employees an equity interest in their companies. And the trend could easily accelerate. Senate Finance Committee Chairman Russell B. Long (D–La.), for one, is an enthusiastic convert and has helped push through two major bills with provisions encouraging the establishment of ESOPs, plus two minor ones, and more are in the legislative hopper.

Little interest.—Employee stock ownership plans are nothing new, of course, having existed for decades in the form of stock-bonus, profit-sharing, and other so-called money-purchase benefit plans that invest a major portion of corporate contributions in employer stock. Like other benefit and pension plans, such ESOPs normally qualify for special tax treatment in the sense that the funds contributed are tax deductible and are not subject to personal income taxes until they (and investment gains) are distributed to employees—usually upon retirement.

Although such plans have not been particularly popular, recent legislation makes them far more attractive. The pension reform act of 1974 (ERISA) not only exempts ESOPs from the diversification requirement that governs the investment policies of most other benefit plans, but it also singles out certain kinds of ESOPs as the only types of plans that can be used as vehicles for corporate borrowing—thus permitting them to be used for a variety of purposes, such as raising capital for investment, restructuring existing debt, facilitating estate planning, recapturing past tax payments, and helping to finance acquisitions and divestitures.

At the same time, last year's tax reduction act offers companies a big incentive to set up ESOPs. A company can now add an extra 1% to the 10% investment tax credit available to it for 1975 and 1976 if it agrees to distribute the tax savings to employees through an ESOP. The action costs the company nothing except administrative expenses, and everyone from the top brass down to the lowest-paid worker can share in the largesse.

COMPANIES THAT ARE JOINING THE ESOP PARADE INCLUDE HALLMARK AND E-SYSTEMS

A slow beginning.—So far, business has been slow to respond to this incentive, partly because the concept is so new, and few concrete guidelines have been issued by the IRS. In recent weeks, however, several major corporations, including Mobil Oil, Atlantic Richfield, and Union Oil of California, have said they plan to set up tax-credit ESOPS.

Since companies can wait to adopt a tax-credit ESOP until the day their 1975 tax returns are filed, the pace of announcements should speed up soon. American Telephone & Telegraph Co. and several utilities have indicated they would go ahead if Congress approves some rule changes.

If all eligible companies were to set up such ESOPs, the cost to the U.S. Treasury could hit some $700 million in foregone tax receipts for 1975 and 1976. But experts say the tax incentive is attractive primarily to capital-intensive indus-

tries. "In many companies with large payrolls, the benefit per employee would be negligible," says W. Gordon Binns Jr., assistant treasurer of General Motors Corp., noting that more companies would undoubtedly join the ESOP parade if the tax credit is extended beyond 1976. GM itself is studying the idea.

Everyone wins.—Meanwhile, interest has been growing in the so-called Kelso-type ESOP, which can be used to raise employee benefits and new capital for the company at the same time. Typically, the gambit works like this: A company that needs cash for investment sets up an ESOP that borrows, say, $1 million from a bank or other lender and uses it to buy newly issued corporate stock. The loan is collateralized with the stock and cosigned by the company, which commits itself to make annual contributions to the ESOP sufficient to cover principal and interest repayments. As the debt is paid off, the shares are allocated to individual employee accounts for distribution upon retirement.

ESOP enthusiasts claim several advantages for this type of strategy:

For corporations, the big plus is that the loan is paid back with pretax dollars. Under conventional debt financing, only the interest payments would be dedubtible, and a company would have to earn $2 million to repay $1 million in principal (assuming it is in a 50% bracket). By using an ESOP as its borrowing vehicle, it saves $500,000 in taxes, reducing the cost of the loan and boosting cash flow. Moreover, management has given the employees a vested interest in improving corporate profitability.

Lenders look as closely at ESOP financing as they do other loans. Nonetheless, as Steven Lee, a consultant with Bankers Trust Co., points out, "Lenders appreciate the fact that the loan can be paid back twice as fast and that executives and other employees have an added stake in the company's performance."

Employees gain when the ESOP is added to existing benefits or when ESOP financing permits a company to set up a benefit plan where none existed before. Even when the ESOP replaces another plan, employees often profit, says Kelso, "because contributions are usually made close to the maximum allowable rate of 15% or 25% of payroll to facilitate the loan rather than the 7% rate typical of regular benefit plans."

Not for all. Despite these potential advantages, experts warn that ESOP financing is far from everyone's cup of tea. "It makes no sense for a company that isn't sound, profitable, and in a high tax bracket," warns Neil Wassner of Main Lafrentz & Co. "And because of the limit on annual contributions, a company's payroll should be no less than $250,000 and ideally $500,000 or more."

Don Sullivan, vice-president of Towers, Perrin, Forster & Crosby, warns that ESOPs "can dilute the interests of present shareholders." Under a straight equity offering, he notes, cash flow, net worth, and net earnings are all higher than with an ESOP because there are no financing costs to be met and no debt to be recognized on the balance sheet. On the other hand, regular debt financing also results in higher earnings per share since the repayment of principal is not a charge against earnings. And although cash flow is initially lower, the eventual investment payoff does not have to be shared with new shareholders.

Lee of Bankers Trust, however, points out that the equity markets remain closed to most companies, and cash flow concerns can inhibit the utilization of conventional debt. "In cases where the investment promises to produce a return greater than its cost of capital and the company's traditional return on equity, ESOP financing can clearly benefit everyone," he says.

What to watch for. Experts point to other drawbacks. Private companies, for example, must establish the fair market value of their shares through an independent appraisal subject to IRS approval. But there is always a chance that the valuation will be successfully challenged later by the IRS or a dissident employee, with heavy penalties to the company. Moreover, private companies may some day be forced to buy back the shares of retiring employees, with a negative impact on future cash flow.

The biggest potential danger, according to many observers, is that some businessmen will use ESOPs to bail out of shaky enterprises. Wassner of Main Lafrentz thinks this danger is exaggerated, however. "Lenders look very closely at a company contemplating ESOP financing," he notes. "Further, everyone involved in an ESOP transaction, from corporate officials and appraisers to trustees, may be personally liable under the fiduciary rules of the pension reform law."

Even the most successful company can suffer reversals, however, and many observers question the wisdom of putting all employees' benefit eggs in one basket.

For that reason, Nathan Kolbes, a Pennsylvania consultant, advises his ESOP clients "either to maintain existing pension programs or to plan to add them when feasible."

SMALL COMPANIES ARE USING ESOP TO FORESTALL TAKEOVERS AND TO GO PRIVATE

Frederick Teague, vice-president of Booz, Allen & Hamilton Inc., points out that the shares in an ESOP trust are normally voted by the trustee appointed by the company, "but Congress could insist on a pass-through of voting rights in the future." Leonard Yerkes III, head of Wells Fargo Bank's corporate finance department, sees dangers if the company begins to go downhill. "Under the prudent man theory, the trustee should liquidate the investment—but how?"

The vanguard.—Despite these potential pitfalls, the Kelso bandwagon is rolling, and experts estimate that close to 300 ESOPs have been set up in recent years. Last year, for example, Gamble-Skogmo, Inc., the big Minnesota-based retailer, turned its thrift and profit-sharing plan into a full-fledged ESOP with a credit line of several million dollars. The object: to pick up G-S stock when it was selling on the New York Stock Exchange at under five times earnings and less than half of book. "We're not using it to raise capital for the company," says Louis E. Dolan, vice-president, "but to benefit our employees, who will get the stock at the price we paid for it."

Similarly, E-Systems Inc., another Big Board company, used an ESOP in 1974 to pick up some 500,000 shares of company stock for its employees through a $7 million tender offer. "We wanted to increase employee motivation and productivity, and with the help of intensive communications programs, we think we are succeeding," says Harry L. Thurmon, vice-president and treasurer of the Dallas-based electronics company. Thurman reports that turnover and absenteeism are both down sharply, and employee suggestions have more than doubled. All of the company's five unions have "cordially" accepted the ESOP, which comes on top of its regular retirement programs.

Many small, fast-growing companies with high cash needs have turned to ESOPs as the first step in providing for their workers' retirement. Two years ago, for example, Steiger Tractor Inc. of Fargo, N.D., borrowed $1 million for expansion through a newly established ESOP. "We're 100% with the idea of letting our employees share our growth," says David Koentopf, financial vice-president of the company, the sales of which have jumped from $5.6 million in 1971 to $82.7 million last year.

One of the main uses of ESOPs by private companies has also been to forestall a sale to outsiders by providing a market for closely held shares. Thus, Hallmark Cards Inc. converted its profit-sharing plan to an ESOP last year partly to assure its 10,000 employees, who already enjoy pension and life insurance benefits, that the company will not go the merger route after its founder, Joyce Hall, and his wife die. Says Bill Johnson, director of corporate communications: "We wanted to share ownership with our employees and demonstrate that Hallmark will be staying in Kansas City."

A growing use of ESOPs has been to facilitate the divestiture of subsidiaries by large companies. This week, for example, the trustees of Omega-Alpha Inc., which is currently being reorganized under bankruptcy proceedings, announced that they were selling the company's Okonite Co. subsidiary to an Okonite ESOP for $38 million.

"Make it grow faster."—To Louis Kelso, the man most responsible for the mushrooming interest in employee stock ownership plans, the ESOPs that have been springing up are only the vanguard of what he hopes will become a major movement. He has long argued that the basic cause of the nation's economic ills lies in the maldistribution of wealth, which results in a chronic gap between production and consumption and the need for ever greater government intervention to redistribute income and manage demand. He believes that using ESOPs to finance new investment would restructure both wealth and income patterns in a fairly painless way. "The point," he says "is to make the pie grow faster and distribute the new growth more equitably."

To some observers, all of this is "pie in the sky," but Kelso's analysis has a certain pragmatic logic that many find appealing. Unlike traditional economic theory, which tends to stress labor as a major factor of production, Kelso holds that capital goods are the main producers of wealth and growth in a modern economy. Because capital ownership is already highly skewed, the common methods of financing new investment (mainly through retained earnings and

debt) increases the concentration of wealth. The result is increasing efforts by labor to boost its share of national income, a quickening of inflation through the wage-price spiral, and the intervention of the government to alternately brake and accelerate the economy. "The system today aggravates the trends toward concentration and socialism," says Kelso. "The answer is a democratic capitalism."

Kelso's game plan goes beyond making ESOPs the principal source of investment financing. He would also do away with the double taxation of dividends, phase out the corporate income tax, and encourage companies to distribute most of their earnings to shareholders—thus providing a significant second income to wage earners. He would also establish special stock ownership plans for consumers and government workers, set up insurance funds to insure employee accounts, and empower banks to borrow low-interest ESOP funds directly from the Federal Reserve.

Until now, most economists have dismissed Kelso's ideas out of hand—partly because such a radical restructuring of the economy seems totally unrealistic and partly because he turns many economic concepts upside down. "Kelso really doesn't understand how the economy works," says one academic economist, "and he has compounded his problems by launching a hysterical attack on the profession."

Nonetheless, a few economists have become intrigued with Kelso's theories. James L. Green of the University of Alabama terms them "the only viable alternative to wage and price controls and state planning." Abel Beltran-del-Rio of Wharton EFA, Inc., the econometric research organization, acknowledges that Kelso's program is "theoretically weak and inflated in its claims," but he feels that it "contains nuggets of gold surrounded by mud."

KELSO SAYS ESOPS CAN INCREASE PRODUCTIVITY AND RAISE CAPITAL FOR GROWTH

In light of the growing interest in ESOPs, several economists have begun to look more closely into Kelso's ideas.

Wharton EFA itself, is planning an econometric study testing the potential impact of Kelso's proposals and other capital diffusion schemes on the U.S. economy. And Carter Bacon of the Congressional Reference Service of the Library of Congress, is at work on a background report. "There's no question that ESOP financing can help some companies," he says, "and it seems likely that investment and savings would be higher in an economy that functions that way. But implementing such a change would raise serious questions of equity and would risk unsound patterns of capital allocation."

For the moment at any rate, such questions are not fazing Kelso and his followers on Capitol Hill. Among other bills they are pushing is the so-called Accelerated Capital Formation Act, which would remove the limit on employer contributions to an ESOP and make dividends paid on ESOP-held stock tax deductible to employees. If that passes, there may be no stopping the ESOP bandwagon.

ACQUISITIONS

MORE EMPLOYEES RAISE THE ESOP BANNER

The trend toward using employee stock ownership plans (ESOPs) as a vehicle to facilitate the sales of subsidiaries by large companies to their own employees is picking up steam. Merrill Lynch & Co. says it has agreed to sell a major portion of the business of its Lionel D. Edie & Co. subsidiary to an ESOP to be formed on behalf of Edie employees. And the trustees of Omega-Alpha Inc., the conglomerate currently being reorganized under Chapter X bankruptcy proceedings, recently unveiled a plan to sell its Okonite Co. subsidiary to an Okonite ESOP for $38 million.

What has really made such sales possible is a clause in the pension reform act of 1974 that singles out ESOPs as the only type of employee benefit plan that can borrow money for the purchase of the employing company's stock. Typically, the employer (in this case the subsidiary) agrees to make annual contributions to the ESOP to be used to amortize its loan. Since such contributions are tax-deductible, the loan is paid off with pretax dollars.

Within the past year, the subsidiaries of a number of companies such as Gerber Products Co. and Shelter Corp. of America have used the ESOP gambit to acquire their own operations from their parent companies. In most cases, the idea is

suggested by the subsidiary's top executives themselves to ward off a possible sale of the division to outsiders—or to insure its survival.

Enthusiastic.—Until now, the biggest deal of this sort was the sale last year by Amsted Industries Inc. of its South Bend Lathe Div. to an ESOP, which raised the $10 million purchase price with the help of a $5 million loan from the U.S. Economic Development Administration. But the Okonite deal—which also involves EDA financing to the tune of $13 million—would represent the largest 100% buyout by an ESOP on record. Okonite, a wire and cable maker based in New Jersey, is Omega-Alpha's only operating subsidiary, and it produced earnings of $7 million last year on sales of $155 million. "Our 1,800 employees seem enthusiastic about the ESOP concept," says an Okonite spokesman.

Ironically, one motive behind Merrill Lynch's planned sale of Lionel D. Edie is the same pension reform act that has made ESOP acquisitions feasible. Under the law's fiduciary rules—and the 1975 amendments to the securities acts—a company that offers investment advice to institutional clients will be barred in the future from acting as a broker to such clients or selling them securities it is underwriting. Since Edie's main business is investment counseling of this sort, Merrill Lynch has decided to dispose of the subsidiary. While the sale price is still to be determined, some 70% of Edie's 356 employees will reportedly be affected by the transaction. Several of Edie's consulting and investment services will be retained by Merrill Lynch.

Regulatory authorities must still clear the Edie and Okonite ESOP purchases. And the Okonite deal remains clouded by efforts by James J. Ling, the former head of Omega-Alpha, to regain control of Okonite by buying up the parent company's debentures on the open market—a move that has thus far been frustrated by a Securities & Exchange Commission trading ban. Italian interests, which bid some $30 million for Okonite, are also crying "foul" because of the proposed EDA loan to the ESOP.

Meanwhile, ESOP fever seems infectious. Among others, Bates Fabric Inc., a Bates Mfg. Co. subsidiary, is currently considering setting up an ESOP to acquire its own operations.

Appendix XIII

Are ESOPs a Fable?

The idea that employees should share in the ownership of the companies they work for has attracted economic theorists for a long time, and employee stock ownership plans are starting to look like an idea whose time has come. But it is an idea that companies, workers, and Congress should study carefully and skeptically before they jump into ESOPs with both feet.

Spurred by tax incentives in recent legislation, nearly 300 companies have established, or are moving to establish employee stock ownership plans. Dozens of consultants have sprung up to advise corporations on the best way to do this, and with more favorable legislation on the way, the business rush to ESOPs will probably accelerate.

Enthusiasts for such plans see them as nothing less than panaceas. ESOPs, they argue, can become sources of needed capital, boost company cash flow, raise employee morale and productivity, provide new employee benefits, and encourage wider public ownership of corporate stock. ESOPs supposedly would benefit the whole economy by spurring needed capital formation, and then would moderate the wage-price spiral and even reduce tensions between society's haves and have-nots.

Such claims are certainly dazzling. The trouble is that they are mostly unproved. What is clear is that ESOPs offer nearly as many pitfalls as promises. As employees' stock ownership grows, management may find itself unable to make tough decisions that workers oppose. And workers themselves would be putting a lot of eggs in one corporate basket, sharing losses as well as gains. Many economists argue, too, that more equitable ways of stimulating investment in the economy can be found than employee stock ownership plans.

ESOPs can have a legitimate role to supplement other employee benefit plans. But before Congress passes new incentives for setting them up, and before management embraces them uncritically, a lot more study of their long-range implications and potential for abuse is essential. Panaceas often have a way of turning into pandora's boxes.

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APPENDIX XIV

H.R. 462 WITH REVISIONS PROPOSED BY KELSO BANGERT & CO., INC., TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, JANUARY 20, 1976

AN ACT To provide for accelerated capital formation

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. *Title.*—This Act may be cited as the "Accelerated Capital Formation Act of 1976."

SECTION. 2. *Purpose.*—The purpose of this Act is to provide incentives for accelerated financing of the formation of U.S. corporate capital and to encourage voluntary means for broadly diffusing equity ownership among employees of U.S. enterprises both (a) with respect to existing capital, by means consistent with the protection of private property, and (b) with respect to newly formed capital, by means which extend the logic of conventional business finance to corporate employees.

SECTION 3. *Amendment of Internal Revenue Code.*—The Internal Revenue Code of 1954 is amended by adding the following new Section 416 at the end of Subpart B of Part I of Subchapter D of Chapter 1:

SECTION 416—EMPLOYEE STOCK OWNERSHIP PLAN FINANCING

(*a*) *Definitions.*

(1) *Employee Stock Ownership Plan.*—The term "employee stock ownership plan" means a technique of corporate finance that utilizes a defined contribution plan which satisfies the requirements of Section 401(a) and is designed—

(A) to invest primarily in employer stock;

(B) to meet general capital financing requirements of a corporation, including capital growth and transfers in the ownership of employer stock;

(C) to build into employees beneficial ownership of employer stock, substantially in proportion to their relative compensation;

(D) to receive loans or other extensions of credit to acquire employer stock, with such loans or credit secured primarily by a commitment by the employer to make future payments to the plan (which may include dividends on employee stock) in amounts sufficient to enable such loans (and interest thereon) to be repaid; and (or their beneficiaries) with the optional benefits described in paragraph (c)(2), or from providing a reasonable reserve for the repurchase of employe rsecurities from former participants or beneficiaries.

(1) *Dividends on Employer Securities.*—In the case of an employer maintaining an employee stock ownership plan, there shall be allowed as a deduction the amount of any dividend paid by such employer (or its affiliate) during the taxable year with respect to employer securities, provided—

(A) such employer securities were held on the record date for such dividend by the employee stock ownership plan, by an individual stock ownership plan described in paragraph (c)(5) of this Section, or by an individual holding employer securities distributed to him from the employee stock ownership plan; and

(B) any dividend received by such employee stock ownership plan or individual stock ownership plan is distributed, not later than sixty (60) days after the close of the plan year in which it is received, to the employees, former employees and their beneficiaries having accounts under the employee stock ownership plan, or for whose benefit the individual stock ownership plan is maintained, in accordance with provisions of such plan; or

(C) any dividend received by the employee stock ownership plan is applied not later than sixty (60) days after the close of the plan year, to the repayment of acquisition indebtedness (including interest) incurred by the plan for the purchase of employer stock.

(2) *Employer Contributions.*—Notwithstanding the limitations under Section 404(a), there shall be allowed as a deduction to an employer the amount of any contributions paid on account of a taxable year [as described in Section 404 (a)(6)] to an employee stock ownership plan, provided such contributions are applied to the repayment of acquisition indebtedness (including interest) incurred by the plan for the purchase of employer stock.

(8) *Certain Donative Transfers.*—For purposes of Sections 170 (a)(1) and (b)(1), 642(c)(1), 2055(a) and 2522, a contribution, bequest or similar transfer of employer securities or other property to an employee stock ownership plan shall be demed a charitable contribution to an organization described in Section 170(b)(1)(A)(vi), provided—

(A) such contribution, bequest or transfer is allocated, pursuant to the terms of such plan, to the employees (or former employees or their beneficiaries) participating under the plan, in a manner consistent with Section 401(a)(4);

(B) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent), or any person related to the taxpayer (or decedent) under the provisions of Section 267(b), or any other person who owns more than 25% of any class of outstanding employer stock, under the provisions of Section 318(a);

(C) such contribution, bequest or transfer is made only in accordance with the express provisions of the employee stock ownership plan; and

(D) such contribution, bequest or transfer is treated as an employer contribution to the plan for purposes of Sections 402 and 411.

(c) *Treatment of Participants.*

(1) *Allocation of Employer Stock*

(A) Employer stock acquired by an employee stock ownership plan through acquisition indebtedness incurred by the plan, in connection with the financing of capital requirements of the employer corporation (or its affiliates), shall be allocated annually among the accounts of the participants to the extent that contributions by the employer (and dividends received by the plan on employer stock) are applied to the repayment of such acquisition indebtedness (including interest), in accordance with the terms of the plan and substantially in proportion to their relative compensation.

(B) The allocation for each plan year shall represent that portion of employer stock acquired with proceeds of any loan the cost of which bears substantially the same ratio to the cost of all employer stock acquired with proceeds of that loan as the amount of loan principal and interest repaid by the plan for that plan year bears to the total amount of principal and interest payable by the plan during the term of such loan.

(2) *Distribution of Benefits*—Upon retirement or death, or following separation from service, an employee participating under an employee stock ownership plan (or his beneficiary, in the event of death) is entitled to a distribution of his nonforfeitable interest under the plan in the employer securities or other investments allocated to his accounts, in accordance with the provisions of the plan. If the plan so provides, the participant (or beneficiary) may elect (prior to or following separation from service) to receive all or a portion of his distribution from the plan in—

(A) other employer securities;

(B) cash;

(C) a diversified portfolio of income producing assets;

(D) a nontransferable annuity contract; or

(E) any combination of the above.

(3) *Mandatory Repurchase of Employer Securities Under Certain Circumstances.*—An employee stock ownership plan may provide for the mandatory repurchase of employer securities from an individual receiving a distribution thereof if all other outstanding employer securities of the same class, whether or not acquired under the plan, are subject to mandatory repurchase from non-employee shareholders under similar circumstances.

(4) *Taxability on Distributions*—

(A) Upon receipt of a lump sum distribution [as described in Section 402(e)(4)(A)] from an employee stock ownership plan, or in the event of termination of an employee stock ownership plan, an individual may exclude from gross income that portion of his distribution from the plan which is held by him in the form of employer securities or is transferred to, and held or reinvested within sixty (60) days in, an individual stock ownership plan described in paragraph (5) of this subsection, as a rollover contribution described in Section 402(a)(5), for the purpose of providing that individual with dividends on such employer securities or other forms of realized current income from income producing assets held in such individual stock ownership plan.

(B) Upon subsequent sale or disposition of any such employer securities (except upon death), or distribution of any such assets from the individual stock

ownership plan, to the extent that proceeds realized from such sale, disposition or distribution are not exchanged for other employer securities, or reinvested within sixty (60) days in income producing assets under an individual stock ownership plan, the total amount of such proceeds (or the fair market value of any property transferred without adequate consideration) shall be treated as ordinary income to that individual.

(5) *Individual Stock Ownership Plans.*—An individual stock ownership plan which is established to receive proceeds distributed from an employee stock ownership plan, as described in paragraph (4) of this subsection, shall be an individual retirement account under Section 408(a), in all respects, except that—

(A) the requirements of paragraphs (6) and (7) of Section 408(a) shall not be applicable;

(B) the taxes provided in Sections 408(f) and 4974 shall not be applicable;

(C) the total realized current income (excluding gains on the sale of assets) of the plan must be distributed, not later than sixty (60) days following the close of the taxable year in which such income is received by the plan, to that individual for whose benefit the plan is maintained; and

(D) the plan may only hold amounts which are attributable to distributions from an employee stock ownership plan.

(6) *Taxability of Dividends.*—An individual receiving a distribution under paragraphs (b)(1) or (c)(5)(C) of this Section shall be subject to taxation under Section 402(a)(1), and the provisions of Section 116(a) shall not apply to such distribution.

(7) *Limitation on Accumulation*—

(A) A contribution by an employer which is deductible under paragraph (b)(2) of this Section, or a transfer described in paragraph (b)(3) of this Section, and any forfeitures attributable thereto, shall not be included in the meaning of annual addition under Section 415(c)(2).

(B) No contribution to (or forfeitures under) an employee stock ownership plan may be allocated to the accounts of any individual if the total value (as of the close of the plan year) of the employer securities and other investments accumulated under the plan for the benefit of that individual equals or exceeds $500,000, less the amount of any such accumulation for that individual under any other employee stock ownership plan (including amounts held in any individual stock ownership plan established under this Section).

(*d*) *Special Provisions.*

(1) *Fiduciary Responsibility.*—The acquisition or holding of employer stock, or the incurring of acquisition indebtedness for the purchase thereof, by an employee stock ownership plan shall satisfy the exclusive benefit requirement of Section 401(a) and the fiduciary duties under Section 404(a)(1) of the Employee Retirement Income Security Act of 1974, provided—

(A) the conditions of Section 4975(d) (3) and (13) are satisfied with respect to any transaction between the plan and a disqualified person; and

(B) the same standards of produce and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

(2) *Procedure for Advance Opinions.*—Upon application by an employee stock ownership plan, the Secretary of the Treasury or his delegate shall, within sixty (60) days, issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraph (1) of this subsection, and any such opinion shall be binding upon the Secretary. Such opinion of the Secretary or his delegate shall be a determination with respect to qualification for purposes of Section 7476(a), relating to certain declaratory judgments of the Tax Court, except that administrative remedies shall be deemed to have been exhausted after sixty (60) days following application by the plan. The Secretary or his delegate shall, within ninety (90) days following the enactment of this Section, promulgate regulations and guidelines for the implementation of the procedure described in this paragraph.

SECTION 4. *Amendment of Employee Retirement Income Security Act.*—Part 4 of title I of the Employee Retirement Income Security Act of 1974 (Public Law 93-406) is amended by adding the following subsection (d) to section 404:

(d) In the case of an employee stock ownership plan [as defined in section 416(a)(1)of the Internal Revenue Code of 1954], the acquisition or holding of qualifying employer securities, or the incurring of acquisition indebtedness for the purchase thereof, shall satisfy the requirements of paragraph (a)(1), provided—

(1) the requirements of section 408(b)(3) and (e) are satisfied with respect to any transaction between the plan and a party in interest; and

(2) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

SECTION 5. *Effect of Economic Stabilization.*—Payments by an employer to an employee stock ownership plan, as defined in section 416(a)(1) of the Internal Revenue Code of 1954, for the purpose of enabling such plan to repay acquisition indebtedness incurred for the purchase of employer stock, or other contributions to such plan, shall not be treated as compensation, fringe benefits or deferred compensation payments for the purposes of any laws, Executive orders or regulations designed to control, establish guidelines or otherwise stabilize employee compensation or benefits, but shall be treated as the equivalent of debt service payments made in the normal course of financing the capital requirements of that employer.

APPENDIX XV

SIGNS OF CRISES IN ECONOMIC THEORY

1. "Normal science can proceed without rules only so long as the relevant science community accepts without question the particular problem-solutions already achieved. Rules should become important, and the characteristic unconcern about them should vanish whenever paradigms or models are felt to be insecure. That is, moreover, exactly what does occur." p. 47.

2. "Because it demands large-scale paradigm destruction and major shifts in the problems and techniques of normal science, the emergence of new theories is generally preceded by a period of pronounced professional insecurity. As one might expect, that insecurity is generated by the persistent failure of the puzzles of normal science to come out as they should. Failure of existing rules is the prelude to a search for new ones." pp. 67–68.

3. "If the complexity of a 'Science' increases faster than its accuracy in problem solving beware: a crises is at hand." pp. 68–71. "Proliferation of versions of a theory also foreshadow a paradigm crisis—the discrediting of a theory." p. 7.

4. Mr. Kuhn makes absolutely clear the vital role of crises in making possible the recognition of innovation.

5. He also points out that so long as accepted theory solves most of the problems, innovation is unlikely. (p. 76)

[From The Structure of Scientific Revolutions, by Thomas S. Kuhn, University of Chicago Press, 1970.]

APPENDIX XVI

[1971, The London Observer]

SOCIAL ORDER CHANGING—TECHNOLOGICAL LEAPS OF INDUSTRIAL REVOLUTION SHIFT BALANCE OF POLITICAL, ECONOMIC POWER

(By Arnold Toynbee)

The industrial revolution is a revolutionary change in the nature of the agent who does the world's work. It is a replacement of people by machinery. In Britain, where this revolution broke out first, it has been going on for 200 years and it is continuing everywhere at an accelerating speed.

It its first phase, its human victims were mostly manual workers. Asian as well as British manual spinners and weavers were put out of business by British machines.

In our own lifetime, the invention of computers has begun to victimize mental workers as well. Computers, doing sums in binary arithmetic at lightning speed, can do bettter than human minds in keeping accounts and perhaps even in making at least minor executive decisions.

Automation—a new name for mechanization raised to the nth degree—threatens to make most people economically superfluous. In other words, it threatens to turn the majority of us into unemployed persons, living on a dole, or—if you prefer to state the same fact in nicer words—it promises to turn the majority of us into rentiers living on unearned incomes.

This social consequence of automation was foreseen as soon as automation itself. Today we have traveled far enough along the road to be able to begin to discern how this social revolution is working out.

POWER POLITICS

The process is the play of power politics: the result is an inequitable distribution of society's aggregate product, income, and wealth. In the aggregate society will be richer than in past, since machines are more potent than people or oxen for producing material goods and services. But this increase in aggregate wealth is not going to reduce the age-old inequity of its distribution.

In the affluent automated society the poorest people will be still poorer than before—poorer relatively, and perhaps poorer even absolutely. The distribution of wealth will change because this is determined by the balance of power, and the balance has been changed drastically by the industrial revolution's progress. Power politics do not make for justice.

In the use and abuse of power, man is the same old Adam today as he has always been.

FOUR MAJOR CHANGES

The current change in the balance of power is the result of four changes in the technological and the social situation.

First, society has become dependent on public service for the supply of daily necessities of life which people were formerly able to provide for themselves independently.

Secondly, the cost of making and operating machines has increased as the machines themselves have become more high-powered. Costly machines are not profitable if, once installed, they are not kept working uninterruptedly.

Thirdly, automation cannot eliminate human agents completely. Unlike a living organism, a machine cannot look after itself and cannot reproduce itself. The "man-power" required for making and operating machinery may be reduced to a minimum by automation, but there will be a minimum that will be irreducible and indispensable.

Fourthly, the human agents who are still needed for making an automatic world work increased their power over society by unionization. Their solidarity gives them a monopoly, and this monopoly gives them a stranglehold.

STRIKE WINS

These four new facts, in conjunction, enable indispensable unionized workers to exert extreme pressure on society by striking. Strikes in public services that supply the daily necessities of life can paralyze society instantly. Strikes in industries whose products are not daily necessities can ruin these industries by putting their costly plant out of action.

Being human, the unionized workers in high industrialized countries are using their power to extract from society the lion's share of society's aggregate income. They cannot, of course, extract more than the total amount of society's real income.

If their demands, in terms of money, exceed this amount, the result is inflation, and the victorious strikers' real gains fall short of their nominal gains in a currency that is being depreciated by their action. Meanwhile, the strikers' fellow citizens who do not share the strikers' power of paralyzing society are not making even any nominal gains, while the inflation is inflicting real losses on them.

In this situation, the distribution of society's aggregate real income is determined, not by the social value of people's work, but by their ability to paralyze society quickly.

People who are able to cut off light, heat, and power, or to put the sewers out of action are in a stronger bargaining position than surgeons, doctors, hospital nurses, educators, researchers and inventors.

If the medical profession strikes, some people whose lives could have been prolonged will die immediately, but not the majority of the population. If teachers strike the damage to society through illiteracy will not begin to be felt for years. If researchers and inventors strike, the penalty will be paid mostly by people still unborn, and consequently the living generation will not take a researchers' strike seriously.

IMMEDIATE IMPACT

Thus the present situation puts a premium on ability to damage society immediately, while it does not reward ability to benefit society eventually.

The redistribution of society's aggregate income on this basis augurs ill for society's prospects. Yet this is the basis for redistribution that is being dictated by the new balance of power.

The consequence is an aggravation of the struggle for shares in society's aggregate income. On the one hand, the "white-collar" workers in the industrially advanced countries, and the governments of the industrially backward countries that produce indispensable raw materials, are copying the industrial workers' strategy. They are fortifying their bargaining power by unionization.

On the other hand, the owners of industrial plant and the authorities who have to provide public services are reducing the number of human employees to a minimum by carrying the process of automation farther and farther.

A unionized human employee is as costly as a machine, but, unlike machines, human beings are troublesome, and their behavoir is unpredictable. They are mulishly wilful, whereas a machine, being inanimate, is more docile even than an ox. The incentive for replacing people by machines is strong.

GRIM MUSICAL CHAIRS

What, then, is the outlook, supposing that the consequences or our present behavior do not move us to behave differently?

Today we are playing, in deadly earnest, the children's game of musical chairs. Each time the music starts, one more chair is removed from the row. Each time the music stops, one more player fails to find a seat and has to go to the wall. If we play this game to its conclusion, the last seat left will be occupied by a minority consisting of the most effective saboteurs.

This victorious minority will be extracting enormous salaries. Because it cannot extract from society more than society's total real income, the minority will have to leave some fraction of this for providing a dole for the unemployed majority.

This majority will consist of the "under-thirties" and the "over-forties." The "under-thirties" will not be allowed to compete for remunerated employment unless they have obtained a Ph.D. degree. The "over fifties" will be retired compulsorily, and the doctors will be allowed to keep them alive until they have reached the maximum permissable age (this will probably be eighty).

ULTIMATE LOSERS

Is this the kind of society that we want? If it is not, we shall have to change our tune. At present we are behaving like blind cut-throats.

Is this civilized? Is it human? On a long view, is it even in the interests of the eventual winners in this sinister game of musical chairs? They, too, in their turn, will reach retirement age. This will overtake them swiftly, and then they will have rejoined the wretched majority. Do they relish this prospect?

The CHAIRMAN. Next we will call on Mr. C. V. Wood, Jr., chairman, the Committee of Publicly Owned Companies, accompanied by Mr. V. B. Pettigrew.

You are recognized for 10 minutes, Mr. Wood.

STATEMENT OF C. V. WOOD, JR., CHAIRMAN, THE COMMITTEE OF PUBLICLY OWNED COMPANIES, ACCOMPANIED BY V. B. PETTIGREW

Mr. WOOD. My name is C. V. Wood, Jr. I am president of McCulloch Oil Corp. and chairman of the Committee of Publicly Owned Companies. The committee is a voluntary organization of the chief executives of 667 companies, all of which are publicly owned. Our members are located in virtually every State in the Union. Their combined assets are $98 billion. They have 3.9 million shareholders and 2.4 million employees. Most of our members are small or medium-sized companies, but some of them are very large, such as Chrysler, General Telephone and Electronics, LTV, and Reynolds Metals.

With me today is Mr. V. B. Pettigrew, chief financial officer of E-Systems, Inc., who, with your permission, will make a short statement following my brief remarks. Our counsel, Abe Fortas, is also here with me.

All of our members share a common concern. It is the shortage of capital without which they will not be able to supply the goods and services and jobs that America needs.

We are here today because corporate America is looking to this committee for salvation—not just our own salvation as companies, but the salvation of our Nation—its economy and its ability to provide the jobs that are and will be needed by America's people.

Our committee started about 3 years ago. Its purpose was simple: to alert America to the critical need for more capital—more equity capital—for corporate America. Today, I believe everyone acknowledges the need. But we still have not taken effective measures to do something about it.

Gentlemen, let me be blunt. There is only one way to meet corporate America's need for equity capital within the American system. That way is substantially in your hands. It is to make changes in our tax laws which (1) will have the effect of directing more of the income of the people of this Nation to investment in companies which produce goods, services and jobs—that is, to investment in corporate America; and (2) will allow America's productive corporations to use more of their capital resources and earnings to retool, expand and invest in more and better facilities, and produce more employment.

That is the problem. That is the challenge. Revisions in the tax law are the only way that, across the boards, we can do the job. There is no alternative.

I suppose some people say that corporations can finance their equity needs out of profits and retained after tax earnings. It is not true.

First, we have fallen so far behind in updating our plants and facilities that the amounts needed are staggering: $23 billion a year over the next decade or $230 billion in all. Some of this—Alan Greenspan says about $48 billion or one-fifth of the total over the next decade—will be needed to comply with environmental laws, and much of that $48 billion won't add to our productive capacity. The balance is to meet changing technology, for example, in communications, agriculture, mining, et cetera, and to meet the needs of population increases.

Second, the Department of Commerce figures show that retained, aftertax earnings have fallen from $29.4 billion in 1966 to $7.6 billion in 1974, a staggering decline, and, if you eliminate foreign operations and look only at retained earnings from domestic operations, 1974 showed a negative figure, a loss in retained earnings of $2.3 billion, that is, on domestic earnings in 1974, American corporations paid out $2.3 billion more in taxes and dividends than they earned. There just isn't any realistic possibility that aftertax profits and retained earnings will be available in amounts anywhere near those necessary to meet more than a fraction of the need for capital.

Maybe there are some who think we can borrow money, particularly now that interest rates are lower. This is an illusion, and probably a suicidal illusion. The bluest of the blue chip companies may be able to borrow money from the banks or the public, but 90 percent of Amer-

ican companies can't and shouldn't. Their debt has soared to historic highs. Corporate debt-equity ratios were 24 percent in 1960. In 1975, they reached the dangerous, astronomical heights of 43 percent.

There may be others who believe that the way out is not to redirect the tax burden, but to have the Government provide the needed equity capital. We reject that, and I think you do, too.

Finally, many people think that if the Congress will just reduce taxes on the average citizen, he will spend more money, buy more goods and services, corporate profits will increase and corporations will have the earnings needed to invest in capital facilities. Well, we are in favor of lower taxes for everybody. Who isn't? But this won't meet the problem. On the contrary, even if it is possible, less taxes on individuals will mean increased pressure of demand on inadequate production, that is, more inflation, and it will mean continued unemployment at a high rate.

This theory, I call it the bubble-up principle, will aggravate and not cure our anemia. We need rifleshot answers to our need for more capital, not a spray gun. If we believe that corporate America needs equity capital, let's adopt measures to direct and deploy our national income, the fruits of our GNP, to supply that capital, directly and economically. Let's not indulge in the destructive, self-contradictory, and roundabout illusion that we can meet the needs for more productive facilities by increasing the demand for them and the pressure on them.

The tried, tested and effective way that is available to meet our needs is through our tax system. This is the American way, combining maximum freedom with basic incentives. We are here today to urge you to make a beginning. We realize the practical limitations under which you must operate; and the proposals which we advocate, are modest and well within these practical limitations.

We believe it is essential to change the tax laws so as to make it more attractive for Americans to invest in America's productive enterprises.

For this purpose:

1. We urge that the first $1,000 of capital gains by individuals on securities transactions in any year should be excluded from adjusted gross income. This principle is incorporated in bills introduced by Senator Bentsen, S. 2799, and Senator Fanin, S. 2909, with the cosponsorship of Senators Curtis and Hansen, by Congressman Archer, H.R. 5368, and Congressman Kemp, H.R. 8053.

A study commissioned by our committee concludes that the maximum loss of tax revenue from this measure would be only $384 million.

At the same time, we believe it will have a major effect in reversing the flight of individual investors from investing in corporate stocks. As you know, the number of individual investors owning shares in America's free enterprise system has been declining, on the average by more than 1 million shareholders in each of the past 5 years.

The recent upsurge in market volume and averages should not be taken as an indication of a reversal of this trend. It reflects the reentry of institutions into the market, and the increase in market price averages largely reflects higher market values for the blue chip stocks in which institutions trade. It has been of minor consequence to the vast majority of American companies, the red chip and the white chip companies.

There is dramatic proof of this: (1) The Dow Jones industrial average based on 30 blue chip stocks is around the 1,000 mark, but the Value Line composite average of 1,500 stocks is around 90, less than half of its 1968 high. (2) The average stock on the New York Stock Exchange is only about 40 percent of its peak, the average stock on the AMEX is only about 25 percent of its high. (3) About 72 percent of the 2,558 companies listed on the New York and American exchanges are currently selling at price-earnings multiples of 10 or less, despite the recent surge in the Dow Jones average. (4) Dramatic evidence that the small investor is still leaving the stock market is provided by the figure as to odd-lot trading on the New York Stock Exchange. Last month, February 1976, small investors sold 11.2 million shares in odd-lots, and bought only 4.9 million shares. The number of odd-lot sales was more than 50 percent greater than a year ago and the odd-lot purchases were even less than a year ago.

2. We urge that the capital gains tax should be stepped down progressively, depending on the length of holding, but we respectfully submit that the present 25 percent rate of tax on capital gains should be retained as the first step, applicable to assets held for 6 months.

3. We endorse the provision in the Tax Revision bill passed by the House which expands the maximum annual capital loss deduction from $1,000 to $4,000 of ordinary income, H.R. 10612, section 1401. This is also included in Senator Bentsen's bill, S. 443.

4. We endorse the principle of encouragement of stock ownership by direct tax incentives. Many companies have adopted, or are seriously considering, employee stock ownership plans as a result of the tax benefits and other legislation recently adopted. We believe that this is a highly significant development which promotes corporate democracy, promises to improve management-labor relations, and provides a useful and constructive means for equity investment. We are aware of the leadership of the Chairman of this committee, Senator Long, in this highly important development, and we support its further evolution.

5. We believe it is also essential to effect changes in the tax law so as to enable companies to build their capital resources. In this connection, we strongly support the excellent Investment Incentives Act of 1976, introduced by Senator Fannin with the co-sponsorship of Senators Curtis and Hansen.

The cornerstone of a sound national capital formation program should be to begin to get rid of the bias in the tax laws favoring the use of corporate debt and discriminating against equity securities. Corporate America is overloaded with debt. I repeat that we need equity financing. We cannot tolerate much more debt. We must begin to allow deductions for dividends, and not merely for interest paid. This can be done by allowing either the individual recipient or the corporation paying dividends to obtain a deduction. Senator Fannin's bill proposes to permit individuals to deduct dividends, within limitations, if they are reinvested in common or preferred stock. It also proposes to permit domestic corporations to deduct dividends paid on preferred stock. These are highly constructive proposals, to which we would add the alternative of permitting corporations themselves to deduct 10 percent of dividends paid on all stock, common or preferred.

Finally, we applaud Senator Fannin's proposal for an increase in the investment tax credit on a permanent basis, and for increasing the corporate surtax exemption and reducing the surtax rate, to more realistic levels than presently in effect. We believe that these measures would be of material aid in allowing companies to accumulate the capital that they need for production and for jobs.

In conclusion, I want to express my thanks and those of the members of the Committee of Publicly Owned Companies for your consideration.

Mr. Pettigrew has a few remarks.

Mr. PETTIGREW. I am V. B. Pettigrew of E-Systems. We are a high technology company that has had a lot of visibility this year on the Sinai support mission program. We are the buffer zone contractor working with the State Department.

E-Systems employs about 7,000 people in the United States today. Approximately 30 percent are engineers. It is a labor intensive company, using little basic material. It creates products which use large numbers of electronic components which are, in many cases, highly complex advancements of last year's state-of-the-art. Obsolescence is a continuous problem, and changes are the way of life. And, the companies supplying the components we use, experience change at an even more rapid rate than we do.

Many of these changes impact capital investments already in place. However, the company is not capital intensive, spending approximately $4 million yearly on the new capital equipment. By comparison, the company spends about $10 million annually on company and DOD sponsored research and development. Approximately 60 percent of our total effort and 80 percent of our engineering and scientific effort is in support of DOD contracts.

Therefore, we live in an environment where capital formation is always critical. DOD procurement regulations do not recognize interest and other necessary items of cost in negotiated prices which simply means they must be taken out of profits. DOD also procures largely on a fiscal year basis and follow-on contracts are negotiated using the latest cost information. This practice frustrates capital investment decisions because the interest cost related to the investment must come from profit, while the profits earned from the investment accrue to DOD on all subsequent purchases.

The competition for capital funds in the major capital markets from the Federal, State, and from the large industrial concerns has severely restricted growth of many companies in the high technology area in the 1970's. Currently, there is some improvement but along with this improvement is a general warning that the overall capital needs of the country will leave most of our industry without long-term debt or equity financing. This leaves depreciation and profit as the source of cash flow with which these industries must fight not only technical obsolescence at home but also cartels, many of which are Government supported, abroad. Depreciation is woefully inadequate in periods of inflation such as we have experienced in the last few years.

The tax deferral we have experienced because of the Domestic International Sales Corporation, DISC, has provided sufficient bottom line profits during its effective period. Export sales have grown from $21

million to $82 million in the last 3 years, and, with sales averaging $30,000 per employee, almost 2,500 of our employees are supported by export sales. While it is impossible to attribute the growth in export sales only to the DISC, it is easy to calculate the benefits to this country in the form of jobs generated by our export business. Changing the DISC to eliminate foreign military sales, FMS, would almost eliminate DISC benefits for E-Systems, with some penalty to future growth.

Almost 3 years ago, E-Systems created an employee stock ownership plan, ESOP, recognizing as we did, the general unavailability of the equity market to us. We have not had to use it for capital formation up to now, but it is ready in the event growth opportunities develop that require equity capital.

We look at ESOP today primarily as a motivational tool, one that we believe must eventually improve productivity as the employees accept the responsibility of ownership. In some ways this benefit is even more important than its use for capital formation, since employee productivity is a very key element in our fight against inflation.

I would like to close with these three short examples:

1. Our prime competitor in the world radio market has a 27 percent subsidy from its government for bringing in foreign exchange.

2. Mostek, a $50 million a year company supplying our industry with integrated circuits, competes with the Japanese, who have created and funded a consortium of six companies who furnish technical talent to develop products to compete with ours.

3. An Irish industrial development agency was in to visit the company last Thursday. They offered as an inducement to build a plant there a package of low interest rate loans under 5 percent, a tax moratorium until 1990, 100 percent depreciation on capital equipment in the year purchased, and other benefits such as employee training.

We have to live in a world where others recognize what capitalism has done for us, where they use practices outlawed in this country as antitrust, where the owner of a company and the company itself are both taxed on the same earnings, and where we, generally, are trying to tax ourselves into the same level of mediocrity existing in much of the rest of the world.

The CHAIRMAN. Thank you, sir. Senator Packwood.

Senator PACKWOOD. When you created the ESOP 3 years ago, what was the form of distribution? Was every employee entitled to receive stock? Upon what basis did you make a differentiation as to who got how much?

Mr. PETTIGREW. All employees are allocated stock based on their salary compared to the total payroll of the company. The company bought stock on the open market with a tender offering and is allocating it over approximately a 5-year period to the employees.

Senator PACKWOOD. The company initially had an outflow of cash return to create the plan.

Mr. PETTIGREW. That is correct.

Senator PACKWOOD. I agree ESOP should be a motivational tool. How can it be very successful in raising, say, $40 million or $50 million in capital? Do you think they would buy up more stock?

Mr. PETTIGREW. $30 million or $40 million in a company of our size would probably be an excessive amount.

Senator PACKWOOD. Is your assumption given the option that the employees would indeed buy more stock if they had some now?

Mr. PETTIGREW. I am sure they would. We made this an additional payroll benefit to our own employees. We did not take anything away from the pension plan that already existed. The ESOP contribution is an additional benefit to the employee. We borrowed the money to buy the stock and the contribution that the company makes each year, pays it back.

Senator PACKWOOD. Are the employees entitled to purchase more stock if they want?

Mr. PETTIGREW. No, they are not.

Senator PACKWOOD. I am intrigued how this can be a significant capital raising device for you if you have to raise stock.

Mr. PETTIGREW. At the moment, our payroll is about $70 million and we are only contributing 2 percent of that payroll to pay off the $7 million we borrowed to purchase the stock, but using a 15-percent limitation as currently permitted, by tax regulation $10 million a year could be raised if you wanted to go to the maximum level.

Senator PACKWOOD. Would you raise it on the basis of the employees purchasing the stock outright or could they have a payroll withholding over a year or two?

Mr. PETTIGREW. We have not faced that problem. We think we probably would at that time contribute it from the treasury, the stock, and either have the employees pay for it through payroll deductions or we could make it as a straight contribution from the company.

Senator PACKWOOD. Have the employees received any dividends on the stock?

Mr. PETTIGREW. They did this year. They did not receive the cash return. Their individual statements show an accrual for the year 1975——

Senator PACKWOOD. If it is not cash, what does it go to?

Mr. PETTIGREW. The distribution will not be made until the loan is paid off that we used to buy the stock. At that point, we think the dividends will flow through to the employees each year.

Senator PACKWOOD. Do the employees have any market for their stock or must they sell it back to the company at a prearranged stock?

Mr. PETTIGREW. They will receive the stock when they leave the company.

Senator PACKWOOD. They can trade it, sell or whatever they want to?

Mr. PETTIGREW. Yes, they can.

Senator PACKWOOD. I have no other questions, Mr. Chairman.

The CHAIRMAN. Just to make clear your previous answers, in providing this capital, there were very significant tax advantages then to the company in putting up this employee stock ownership, were there not, even aside from the investment credit?

Mr. PETTIGREW. Yes; there is a significant tax advantage to the company because the loan is being paid with pretax dollars.

The CHAIRMAN. Assuming you are in a 40-percent tax bracket, almost half of the cost of providing the employees equity in the company did come from a tax savings?

Mr. PETTIGREW. That is correct, sir.

The CHAIRMAN. I wish others would try as you have to motivate their employees by making them feel they are part of all this, as you

have done with your company. May I say to Mr. Wood who testified first, I might be able to go along with your package, Mr. Wood, but I feel like the little boy picked up by the bootlegger. He had his liquor covered over by manure. When he passed by a revenue agent who asked him what he was carrying, he said, "All I have is this load of manure and this orphan boy." After this happened several times the little orphan boy said, "Mister, if it is all the same to you, would you mind introducing me first?"

I see, Mr. Wood, that you endorse employee stock ownership. Maybe the next time you might consider putting that first on your list. I think you have made a fine presentation.

Senator Curtis.

Senator CURTIS. I have no questions.

The CHAIRMAN. Senator Byrd.

Senator BYRD. No questions.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Wood, it is a pleasure to have you with us. I have had the privilege of knowing you for many years and admired your work in relation to this activity and others.

Mr. Pettigrew, you gave us some very fine information, the fact that some information that should be disclosed as to the competitive position we are in, insofar as competition with other parts of the world.

Mr. Wood, I would like to ask you a few questions. Would you support an annual $1,000 capital gains exclusion if it contained a rollover reinvestment proviso such as provided in S. 2909? I understand you have had a chance to look at that act. Have you referred to it in your statement?

Mr. WOOD. Yes. If we had thought of that when we developed our $1,000 capital gains exclusion proposal, I am sure we would have added it. I am glad you thought of it and have added it. I think it is a good incentive to keep investments in equities, absolutely.

Senator FANNIN. Would you elaborate on your comments that small investors and small- and medium-sized companies are not being helped by the recent market surge.

Mr. WOOD. It is pretty simple. We all know that the Dow Jones is up over a thousand but what we call the red and white companies have not been helped. Just the other day, I saw a study which placed the unweighted average for Amex stocks at 60 in 1969. For the last three years, this same average has been hovering at ten. What has happened is that the individuals have left the marketplace—over a million people a year. When they left the marketplace and left the red and white chip companies, the price/earnings multiples went down. The multiples, for many companies are very low now. If you tried to sell equity with a multiple of only five, you would have to make 20 percent on that equity the next year just to keep your earnings stable. It is just impossible.

We have become a consuming nation and not a saving nation. We must provide people with an incentive to save their money and invest in corporate America. That is what provides jobs and keeps everything going. We have to have equity capital. Our debt ratios have gone up in the last 10 years from 24 percent to 43 percent. Some corpora-

tions are going to fail. They can't survive this level of debt-equity ratio. We have to have more equity and we will never get it without an incentive.

Senator FANNIN. I wish the press would pick up your statement as you made it and circulate it around this Nation. I think it is very badly needed to have an understanding of just what is happening. I commend your group for educating the public in this regard and speaking out on these critical problems.

Mr. Wood, I note that your revenue impact study shows an annual $1,000 capital gains exclusion would cost the Treasury a maximum of $384 million. The approach in my bill, requiring a rollover of the gain to qualify for the exclusion, would cost even less. Who prepared the revenue impact study?

Mr. WOOD. Dr. Norman Ture did the study for us. Normally his findings are accepted by the Treasury Department because he works with them all the time. I know you gentlemen are primarily interested in what it is going to cost the Treasury, but on the other side, it will provide much more employment which will result in much more tax income to the country. It will help corporations to be able to pay more taxes. In sum, the $384 million revenue loss is nothing compared to what you would get back and the proposal helps only the little man. We would be happy to submit Dr. Ture's study.

Senator FANNIN. My time is up. Would you submit a copy of that statement for the record?

Mr. WOOD. We will submit it.

Senator FANNIN. Thank you very much.

Mr. WOOD. You're welcome.

[The study referred to follows:]

NORMAN B. TURE, INC.,
Washington, D.C., July 24, 1974.

To: Mr. C. V. Wood, Jr.
From: Norman B. Ture.
Subject: Revenue effects of $1000 annual capital gains tax exclusion.

SUMMARY

1. A simple and effective method of increasing investment in corporate stocks and expanding the volume of transactions and realized gains would be an exemption of $1,000 per year of capital gains on securities transactions, On very conservative assumptions, this proposal would result in a new revenue $384 million.

2. If market-volume were to increase only to the depressed 1973 level, the $1,000 per year exclusion would result in an estimated net revenue gain of about $200 million.

A very effective method of attracting individuals of modest means to invest in corporate equities is the proposal for a $1,000 annual exclusion of gains realized on the sale of corporate shares. While this exclusion would be of relatively limited significance for taxpayers with substantial amounts of accrued gains, hence for unlocking gains on long-held assets, it would certainly be an important and constructive tax revision for the overwhelming majority of individual taxpayers. The $1,000 annual exclusive would provide a strong inducement for investing a larger portion of one's savings in corporate stocks; for a great many individuals, it would significantly reduce or even eliminate the present tax barrier to realization of accrued gains. It would certainly expand the volume of transactions in corporate equities and the amount of gains realized.

By virtue of this expansion of transactions and gain realization, the $1,000 annual exclusion would, at the worst lose very little revenue, and it might well generate a significant increase in tax receipts.

Based on 1971 gains and transaction volume, it is estimated that the initial impact revenue loss would be $600 million. With 1974's depressed stock prices and greatly reduced volume, the initial impact revenue loss would probably be far less. Offsetting revenue increases would depend, of course, on the magnitude of taxpayer response.

Assume, conservatively, that net long-term capital gains average ten percent of the dollar volume of stock transactions. Suppose that the provision of a $1,000 annual exclusion expanded 1974 volume by only ten percent. Assume that with the additional $1,000 exclusion, the overall ratio of total exclusion to gain rose to 60 percent. Then, of the estimtaed $1.15 billion increase in gains, about $460 million would be taxable. At an average marginal rate of 47 percent, this would provide additional revenue of $216 million. Thus, even if the initial impact revenue loss of $600 million were not too high, given 1974's depressed stock prices and volume, the net revenue loss would be only $384 million, based on only a very modest recovery in volume.

If volume were to increase, in response to the $1,000 annual exclusion, only to the depressed 1973 level of $156.8 billion (total of Amex and NYSE), the offsetting revenue increase would be about $790 million. On this conservative set of assumptions, the proposed $1,000 annual exclusion would generate a revenue gain of close to $200 million.

The CHAIRMAN. Senator Ribicoff.

Senator RIBICOFF. I understand you represent 607 companies. I would imagine out of these 667 companies, some comply with the Arab boycott and some do not; is that correct?

Mr. WOOD. That has never been an item for discussion by our committee, so I don't know.

Senator RIBICOFF. Looking at this study, some would probably go along with the Arab boycott and some would not. Would that be your guess?

Mr. WOOD. I just don't know.

Senator RIBICOFF. Say you have an A company that goes along with the Arab boycott and B company does not, and A company is able to get a business contract with X country and B is turned down. Do you think when it comes to foreign tax benefits, A company should get those foreign tax benefits for complying with the boycott as against B company which does not get the business?

Mr. WOOD. As I said, those items have never even been considered for discussion. The primary purpose of our committee is to put every ounce of strength we have to make more equity capital available for American enterprises.

Senator RIBICOFF. Here you are the president of a large company. You have enough prestige to be named as the chairman of a group of 667 corporations, the Committee of Publicly Owned Companies. I want to get your personal opinion.

Mr. WOOD. As I said, and I am just speaking for the committee, we have never addressed anything like that.

Senator RIBICOFF. How big is McCulloch Oil Corp.?

Mr. WOOD. We are a $100 million a year corporation.

Senator RIBICOFF. How many employees do you have?

Mr. WOOD. About 3,000.

Senator RIBICOFF. You must have some ideas on this subject.

Mr. WOOD. We do nothing overseas.

Senator RIBICOFF. What is your own personal feeling on this subject?

Mr. WOOD. I just never spent any time thinking about it.

Senator RIBICOFF. You read about it. You read the newspapers and you know that it is a situation that does exist.

Do you want to make any comment on that, Mr. Pettigrew?

Mr. PETTIGREW. We do operate in all parts of the world and have never had anyone request that we do business with certain nations or not do business with certain nations. We sell to both sides.

Senator RIBICOFF. Suppose that is the case. Suppose you have a competitor who complies with the boycott and your company does not. When you submit a bid or a contract with X country which demands that you do or do not comply, you refuse to comply and your competitor does comply and he gets that business. Should he be getting the tax break from the American people for doing business against American policy and you lose that business? Do you think he should get that break?

Mr. PETTIGREW. Personally, no.

Senator RIBICOFF. Do you think it would be fair to write that into the tax code that under DISC or foreign tax credits or deferral of tax on earnings, that that break be taken away from him?

Mr. PETTIGREW. It would help us, sir.

Senator RIBICOFF. I have no other questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Thank you very much. We are glad to see you here today, Mr. Fortas.

Next we will call on Mr. Paul R. Ignatius, president and chief executive officer of the Air Transport Association.

STATEMENT OF PAUL R. IGNATIUS, PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA, ACCOMPANIED BY WILLIAM SEAWELL AND CHARLES McERLEAN

Mr. IGNATIUS. Good morning, Mr. Chairman and members of the committee. I have a summary statement to give and I have a longer supplemental statement I would hope would be made a part of the record.

With me, I am pleased to introduce Mr. William Seawell on my left, chairman of the board and chief executive officer of Pan American World Airlines. On my right is Mr. Charles F. McErlean, vice chairman of the board of United Airlines and president of UAL, Inc., and who has served for a number of months as chairman of the special committee of the Air Transport Association concerned with the subject on which I am pleased to have the opportunity to testify.

Our association represents almost all of the scheduled airlines in the United States and I appear here today on their behalf to urge your favorable consideration of S. 3080. This bill would help relieve a very serious inequity in the present investment credit program by providing that earned but unused and expiring credits be treated as refundable overpayments of tax.

There is a wide recognition of, and concern about, the unsatisfactory economic condition of the airlines, as well as other segments of the Nation's essential transportation industry and the inability of this vital industry to secure needed capital. The airlines believe that of

all the matters now pending before this committee, S. 3080 represents the single most important action that can be taken this year to assist in meeting the immediate capital formation needs of the airline industry.

The present investment credit program is inequitable because it penalizes companies which make investments but are unable to generate the profits, and resulting tax liabilities, required to make use of the credit. The airlines are prime examples of this unintended inequity.

The investment credit program was adopted in 1962 to encourage investment in capital equipment in order to stimulate the economy and to provide jobs. The airline industry responded by making direct investments of over $16 billion in capital equipment. This investment has provided the Nation with the world's most modern air transportation system. It is providing jobs for 300,000 employees. In addition, it supports hundreds of thousands of jobs in derivative employment, particularly in the aerospace and tourism industries.

This $16 billion of airline investment has generated investment credits of over $1 billion. However, because the benefit of the credit is now distributed only as a reduction in income tax liabilities, the airline industry to date has been able to utilize less than one-third of the credits earned, or approximately $300 million. The airlines already have lost $50 million of earned credits due to expirations. They will have lost another $35 million of credits expiring at the end of 1975 unless S. 3080 is enacted, and they stand to lose an additional $780 million of earned but unused credits facing expiration over the next few years unless this bill is passed.

In short, the airlines have not received any investment credit benefit on two-thirds of the investment they have made, that is, no credit benefit for $11 billion of the $16 billion actually invested. The inability of the industry to generate the profits and tax liabilities against which to use the credit has arisen from circumstances largely beyond the control of the airlines. Major contributing factors have been skyrocketing costs, particularly with respect to fuel, coupled with severe limitations on fare adjustments to recover cost increases. We do not believe that Congress anticipated the expiring credit problem now facing the airlines and other enterprises when the investment credit was enacted. However, time and experience have demonstrated the unfair and inefficient manner in which the investment credit is distributed.

The investment credit was designed to reduce the cost of capital equipment. It has been recognized from the beginning as a tax subsidy to stimulate the economy and create jobs. Loss companies, and break-even companies—especially those in essential industries, such as airlines and railroads—need the benefit of the credit as much, or more, than the profitable companies do.

Profitable enterprises have the cash benefit of the credit paid to them immediately through a current reduction of income tax liabilities. Unprofitable or marginal enterprises, however, not only do not get immediate benefits of the credit, but they may never receive the benefit of the credit under existing law in the absence of tax liabilities. We are not suggesting that unprofitable or marginal enterprises should receive immediate benefit as do the profitable companies. S.

3080 would provide for such benefits only after a waiting period of 7 to 10 years. Given existing interest rate levels, the present value of a refund after waiting 7 years is only about one-half of the value of an immediate cash benefit.

The revenue effort of S. 3080 would be relatively modest. Total refunds of credits expiring in the 3-year period, 1975–77, would represent less than 2 percent of the credits allowed to profitable enterprises over the same period. The impact for 1977 is estimated at $150 million, a very modest amount to help relieve a serious inequity.

Questions may be raised concerning the principle of refunding unused investment credits. For example, some may argue that refundability of credits is an unprecedented concept. Refundability is not unprecedented. The Tax Reduction Act of 1975 provides for a refundable earned income credit. In October of 1974, the administration proposed that unused investment credits be refundable after 3 years. Moreover, your committee in the past has approved refundable credits for expenditures in the case of certain home insulation and geothermal energy equipment, as well as for certain child care programs.

Some may argue that refundability would reward inefficient management. It would not. In regulated industries, lack of taxable earnings is frequently beyond management control. The airlines, in particular, have been adversely affected by the astronomical rise in costs, especially for fuel. Moreover, the "half-a-loaf" credit refund after 7 years would provide a strong incentive to generate taxable earnings in order to gain the benefits of using investment tax credits at an earlier date.

Refundability of credits is not tantamount to a negative income tax. The credits to which the refunds would apply have been earned by investing in the capital equipment which the credit was designed to encourage. Nor is the proposal, as some may argue, a special benefit for just the airlines and railroads. The proposal would benefit all enterprises, large and small, faced with expiring credits.

Leasing is not, as some might suggest, a solution. Although leasing performs a valuable role, for many airlines it is often the financing of last resort. Additionally, there is grave doubt as to the capacity or willingness of the financial community to provide the airline industry significant amounts of leasing capital.

We believe that refunding credits earned in prior years is a matter of simple equity for the break-even and loss enterprises which invested in the capital equipment the credit was designed to encourage. The effect of granting the credit immediately to profitable companies while denying it to unprofitable enterprises means that those with no tax liability, in effect, must pay more for their capital equipment. There is no logical reason for this discriminatory treatment. Moreover, refundability will remove the disincentive to future investment resulting from credit accumulations, and will provide additional capital funds to those who are especially in need.

Refundability will stimulate future capital investment and create jobs, because enterprises which cannot plan on future taxable income could at least obtain some reduction in the cost of their capital equipment. The airline industry has very heavy capital needs over the next 5 years. Based upon conservative assumptions and planning estimates, it will be necessary for the airlines to obtain $6 billion of capital during this period for the acquisition of new aircraft and related equip-

ment to: (1) Provide for expected growth in passenger and freight traffic; (2) reduce maintenance costs through increased standardization and greater efficiency; and (3) achieve greater fuel efficiency, quieter operations, and minimize demands upon the airport and airways system through the operation of better sized and configured aircraft.

Refundable investment credits would reduce the cost of this capital equipment and help provide the necessary funding. Such funding cannot be generated from retained earnings today because airline earnings have been so low. The financial institutions have become highly reluctant to lend money to the airlines, and the equity markets offer little or no promise.

We believe that enactment of S. 3080 would provide a more equitable and efficient distribution of the benefits of investment credits. The airlines consider this legislation to be essential. They believe that enterprise disadvantaged by the inequity of the present investment credit, such as the airlines, are entitled to receive some benefit—if only "half-a-loaf"—from credits earned through their investments.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. As I understand the problem you have discussed, it is—simply stated—that you have made capital expenditures that would generally entitle you to the investment credit. Under existing law, however, you cannot avail yourself of that credit unless you have taxable income.

Mr. IGNATIUS. That is correct, Senator.

Senator CURTIS. Actually, is it not true from the standpoint of the Treasury, that a credit is the same whether or not it is a refundable credit because both constitute a payment from the Treasury?

Mr. IGNATIUS. Yes; it would seem to me to be so.

Senator CURTIS. For the business concern that has income and owes a tax, a credit, unlike a deduction which is subtracted from income, is subtracted from the tax so that so far as the Treasury is concerned, a credit is equivalent to paying the regular tax and getting a check back for the credit.

Mr. IGNATIUS. Yes; I think that is a correct way to view it.

Senator CURTIS. Do I understand your testimony to be that in order for you to make needed capital expenditures, you need the benefit of the investment credit even though you have no taxable income to which we can apply it?

Mr. IGNATIUS. That is correct. We are arguing in effect that the purpose of the initial legislation in 1962 was to stimulate investment because it stimulated the economy and the working people as well as the companies that make up that economy, and the test was whether you made that investment or not, and by that test we made a $16 billion investment in flight equipment against which very little of the credits that were earned thereby will be available to us to meet our future needs.

Senator CURTIS. If a refundable investment credit were of general application, are there other major industries that derive a benefit from it?

Mr. IGNATIUS. The principal industries that have earned but expiring credits are in the railroad and airline businesses.

Based on an analysis that we made, we think that probably 70 percent of these expiring credits would be within the railroad and airline industries with the balance of 30 percent spread across a wide range of other industry groups.

Senator CURTIS. Has anyone made an estimate as to what your proposal will cost if it is applied to all industries?

Mr. IGNATIUS. Yes; we have made that estimate. I can give you a 3-year figure, 1975 through 1977, the credits that would expire are $480 million and I can provide further data for the record.

Senator CURTIS. I would appreciate receiving that information.

Mr. IGNATIUS. We can provide that.

[The information referred to above was subsequently supplied as follows:]

AIR TRANSPORT ASSOCIATION OF AMERICA,
Washington, D.C., April 13, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During my March 31, 1976 testimony in support of S. 3080, which would provide for a refundable investment credit, Senator Curtis asked for information concerning the total amount of credits which might be subject to refund for all industries under this legislation, and whether such refunds would be applicable to individuals as well as corporations. Enclosed is an estimate, on an annual basis through 1980, of the investment credits which will be earned and taken by all corporations and individuals, as well as an estimate of the revenue cost of making earned but unused and expiring credits refundable.

As shown in the first column of the attachment, the revenue cost of investment credits taken during the period 1975 through 1977 under present law will total $26.4 billion, and will total $58.1 billion in the six-year period 1975 through 1980. The second column indicates the amount of credits that would be refundable under the provisions of S. 3080 if it is enacted. These refund estimates include corporations only. Under the provisions of S. 3080, however, individuals having unused and expiring investment credits would be allowed refunds. We believe that the amount of such refunds to individuals would be insignificant and, therefore, no estimate of the refunds for the non-corporate sector is included in the attachment.

Sincerely,

PAUL R. IGNATIUS.

Attachment.

ESTIMATES OF REVENUE COST OF MAKING INVESTMENT CREDITS REFUNDABLE (S. 3080) AS COMPARED WITH REVENUE COST OF PRESENT LAW INVESTMENT TAX CREDIT ("ITC")

[Dollar amounts in millions]

	Revenue cost of present law ITC[1] (1)	Revenue cost of making ITC refundable[1] (2)	Col. (2) as percent of col. (1) (3)
1975	$8,000	$100	1.3
1976	8,900	150	1.7
1977	9,500	230	2.4
1975-77	26,400	480	1.96
1978	10,000	280	2.8
1979	10,600	400	3.8
1980	11,100	500	5.6
1975-80	58,100	1,660	2.8

[1] Col. (1) includes the revenue cost in the noncorporate sector. Credits to be refunded to the noncorporate sector are not included in col. (2) because they have not been estimated, but available information indicates they would be so small as not to significantly affect the comparison of credits to be refunded with credits to be used by profitable enterprises under present law. The available information indicates that the noncorporate sector, which utilizes about 20 percent of total credits, does not have a significant problem with expiring credits.

Senator CURTIS. Do your revenue estimates relate to individual taxpayers as well as to corporations?

Mr. IGNATIUS. These figures, to the best of my knowledge, are based on corporations and not individuals.

Senator CURTIS. Under existing law, how many years can the investment credit be carried forward before it expires and can no longer be utilized?

Mr. IGNATIUS. There is a combination of 7 or 10 years depending on the particular time at which the investments were made and the laws which were in effect at that time.

Senator CURTIS. Was this proposal for a refundable investment credit submitted to the Ways and Means Committee?

Mr. IGNATIUS. We testifed before the Ways and Means Committee last year, Senator Curtis.

Senator CURTIS. Is this proposed in the House bill?

Mr. IGNATIUS. It is not in the bill.

Senator CURTIS. What is the position of the Treasury on this proposal?

Mr. IGNATIUS. We met with the Treasury officials at an earlier point in time. The Treasury recommended a change of this kind but with a change in the basis adjustment, and this is going back several years ago. At the present time, they have not endorsed this concept. We hope that through continuing discussions, they might do so, but they have not endorsed it.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. When the Treasury first recommended the investment tax credit, that was a great departure from the way Treasury had done business down through the years. Historically, the people over in the Treasury had strenuously opposed a tax-credit approach. It was only when Senator Kennedy became President that they came forward with the suggestion that we should have this investment tax credit to stimulate the economy.

As I understand it, the thinking over at the Treasury prior to that time was that if you started with an investment tax credit, it was hard to say where you were going to stop. But this is a very useful tool that has probably done more to stimulate the economy than any other one thing that has been devised up to this point. I think as far as the business segment is concerned, that is correct. If we look upon the investment tax credit for what it really is, it is not like depreciation whose purpose is to let you get your money back when you pay for a piece of equipment. The credit is an incentive for business to make investments, to modernize, to buy new plants and equipment and a subsidy to try to make our industry as efficient as those with whom we are competing around the world. If you look at it on that basis, it is unjust to deny the credit to a new company which is just starting up.

For example, if you are building an atomic generator, it may be 5 to 10 years before you pay taxes. It would be unfair to deny you the benefit of the subsidy until such time as the operation can start paying a tax. In my judgment, a company earns its right to the investment tax credit when it buys the equipment and makes the investment. It may be as a constitutional matter, if we are going to do this for a

company that never paid any taxes to begin with, we should do like we do with the national debt with an appropriation. We have the jurisdiction within this committee to do that. If it upsets the Treasury that this is not really an allowance against taxes, they can call it anything they want to, but it is an incentive for people to make investments for new plants and equipment. I find a lot of appeal for this.

If we do it with regard to tax liabilities that are already behind us and anything that would look retroactive, I would want to insist that the workers as well as the investors benefit from it. I have discussed it with the gentlemen on your left from Pan American Airways and they don't find anything bad about that. I don't think they would object to selling stock to their workers at book value in depressed conditions; is that correct?

Mr. SEWELL. That is correct.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. Mr. Ignatius, you have covered the problems to some extent of capital formation and mentioned that leasing evidently was just a fallback position that you took because you did not have the capital to handle the purchases otherwise. Is that what you have stated?

Mr. IGNATIUS. Yes; there is a portion of our fleet today that has been obtained on the basis of leases, but leasing is not the best way of doing it.

Senator FANNIN. You recognize that capital formation is a major problem facing American business. I think that is generally what you have stated. Would you expand on the capital needs of the airlines in the next 5 to 10 years.

Mr. IGNATIUS. Over the period of the next 5 years, we estimated capital needs on the order of $6 billion. If you extend that for a 10-year period perhaps up to 1985, we estimate something on the order of $20 billion.

I noticed yesterday that the Boeing Airplane Co. issued a press release and their figure was in that same general range with regard to the U.S. domestic market and they commented in that press release that the economic conditions in the industry are such that major airlines cannot make large new commitments. This is a comment on our problem today, Senator Fannin. We don't have enough earnings to retain in order to purchase these airplanes. It is very difficult to sell our stock because the price at which the stock is valued on the stock exchange in many instances is below its present book value.

The debt lenders who have previously been sources of financial assistance to the industry are increasingly reluctant to make financing available to us because of the uncertain earnings, because of uncertainties with regard to the future regulatory climate, and so forth.

Therefore, we believe that this makes it all the more urgent that the capital represented in the $780 million of earned but expiring tax credits be made available to the industry. That is an important measure which will help us to get on with this program.

Senator FANNIN. You mentioned in your testimony that the regulated industries in particular have problems concerning high costs. All industries have, but you have mentioned that those in the regulated industries have particular problems. How has your industry been affected in this matter and why was it unable to correct it?

Mr. IGNATIUS. The most significant cost increase in the last few years has been for fuel, a subject with which you are well acquainted, stemming from the Arab oil boycott and the OPEC increases.

Our fuel from 1973 to 1975 increased in cost to us on the order of $1.5 billion for 1 billion gallons less fuel. We bought less and less but our fuel bill was $1.5 billion more. That additional cost was not recovered in fare increases. The lag between the cost for fuel and the fare increases to account for it, the last time I looked at it was on the order of $600 or $700 million. That is the important aspect of it. Other costs have risen. Our labor costs are the largest single category cost. They have tended to rise more rapidly than the cost of living and more rapidly than in most other areas of industry. So the individual airlines have said repeatedly in their filings with the Civil Aeronautics Board and in public statements that they feel fare increases have lagged behind the cost of living, and that these increases, as in all business, must be recognized in terms of the price charged for product or service.

Senator CURTIS. Thank you very much.

[The prepared statement of Mr. Ignatius follows:]

STATEMENT OF PAUL R. IGNATIUS, PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA

My name is Paul R. Ignatius. I am President of the Air Transport Association of America which represents virtually all of the scheduled airlines of the United States. I appear on behalf of our membership in support of S. 3080, which would make the vitally needed investment credit program available to all companies with qualifying capital investments, including most significantly, many basic transportation companies which presently are not receiving the intended benefit.

INTRODUCTION

The airlines are deeply concerned about their continuing ability to generate the ever-growing amount of capital required to keep this nation's essential air transport system the most efficient and productive in the world. S. 3080 would greatly assist in meeting that objective by correcting a major deficiency in the present law.

As presently structured, the investment credit is neither as effective nor as fair as it should be because the benefit of the credit is now distributed only as a reduction in income tax liabilities. Consequently, the credit fails to provide the long-term incentive for investment to companies which are currently unable to generate the profits and resulting tax liabilities required to make use of the credit. S. 3080 would provide that previously earned but expiring investment credits will be treated as refundable payments of tax at the close of the existing carryover periods—ten years for credits earned before 1971 and seven years for those earned after 1970 commencing with credits expiring in 1975.

We estimate that the credits which would be refunded under S. 3080 to all the nation's business taxpayers for the years 1975, 1976, and 1977 would represent less than two percent of the credits allowable under present law to profitable taxpayers during the same period, or about $480 million as compared with $26.4 billion. Assuming no significant change in industry profitability during this period, the airline portion of these refunds will approximate $175 million.

In view of interest costs, the refund of earned but unused credits after seven years will provide break-even and loss companies with about one-half of the present cash value of the credit received by profitable companies. We believe that break-even and loss companies, which need the benefit of the credit as much as or more than the profitable companies, should be able to obtain at least "half a loaf" toward reduction of their costs of acquiring the capital equipment which has provided jobs, increased productivity, and helped sustain the domestic economy.

The scheduled airlines have been able to utilize less than one-third of the credits earned since 1962 on $16 billion of investment. At the end of 1975, investment credits of about $780 million are unused and due to expire over the next seven years. Many of these credits will simply go down the drain unless the investment credit program is corrected.

S. 3080 will correct the deficiency in current law that precludes effective and uniform utilization of the investment credit incentive by removing the disincentive to invest created by the accumulation of unused and potentially unusable investment credits. This legislation will make the investment credit more effective in providing jobs and increasing productivity by reducing the cost of acquiring capital equipment for businesses both large and small.

IMPORTANCE OF THE INVESTMENT CREDIT PROGRAM

Although the investment credit program initially provided an investment incentive for the airline industry, the full benefit of the incentive has not been realized. An improved and more effective program can and should play a greater role in encouraging the heavy investments required by airlines and other business in the future to stimulate the economy and to provide more jobs.

The history of the airlines of the United States is characterized by heavy investments in the most modern and efficient equipment available, in order to assure that the public receives the full benefit of the continuing advances in aviation technology. This has resulted in numerous re-equipment programs, improved public service, increased airline industry employment, and the stimulation of business and employment for a host of supplier companies as well as for thousands of communities which rely on air transportation for social and economic development.

At the end of 1975 the scheduled airlines employed about 300,000 people, paying nearly $6 billion in salaries and wages, and operated a fleet of about 2,300 airplanes costing $18 billion. The aerospace industry of the United States, the airline industry's principal supplier, employed approximately 125,000 people in 1975, manufacturing aircraft and aircraft parts. Airline employment is nearly equal to employment in the industrial chemical industry, the motor vehicle assembly industry, and is almost 100,000 more than that in the petroleum and coal industry. In addition to airline and aerospace employment, an additional 3.5 million people are employed in the tourism industry which relies heavily upon airline service.

The capital requirements for the acquisition of aircraft have in the past been met through borrowings, internally generated funds, and leasing. Since the enactment of the investment credit program, airlines have undertaken these required investments in anticipation of receiving the benefits of the credit. However, because of low earnings, the airline industry has received less than one-third of the benefit of the earned credits. Some airlines have not been able to use any of their earned credits.

Nevertheless, even with its limited availability, the investment credit during the past decade has contributed to airline productivity at a time of rising operating costs, at the same time helping airlines meet the requirements of substantially increased traffic growth and the environmental/energy challenge. Because new equipment effectively accomplishes these ends, capital investment in newer aircraft and engines must continue. An improved investment credit program would assist the airlines in meeting these capital needs.

AIRLINE INDUSTRY EARNINGS

Airline earnings historically have been highly cyclical in nature and have been less than adequate by any standard. In the recent period 1970–1975, the industry has recorded a total profit of only $500 million on revenues in excess of $73 billion, or a profit margin of less than 1¢ on each dollar of revenue, while the return on total investment (including long-term debt) over this same period was about 4 percent. The return on equity investment during the same period was about 2 percent. In 1975, the airlines lost nearly $100 million, and the outlook this year is that there will be little significant improvement.

Airline earnings have been adversely affected by the condition of the U.S. economy, which has resulted in a lag in traffic growth, and by catastrophic increases in the cost of fuel, as well as escalating wage and benefit costs. For example, the cost per gallon of fuel more than doubled in domestic operations

and tripled in international operations, since the beginning of the fuel crisis in the latter part of 1973. As a result, the airline industry paid a staggering $1.5 billion more for fuel in 1975 than in 1973, even while using about one billion fewer gallons of fuel. Moreover, airline wage and benefit costs have risen over 50 percent during the last five years, compared with an increase of about 39 percent in the Consumer Price Index during the same period. Taken together, airline labor and fuel costs represent about 60 percent of total airline operating costs.

The current uncertain economic situation, together with continued demand for large amounts of additional capital to purchase the ever-improving aircraft and ground equipment, has produced a serious capital structure imbalance. At the present time the airline industry debt/equity ratio is approximately 1.3/1, not including the debt represented by the growing amount of leased equipment now being operated by the airlines, or the volume of locally issued airport revenue bonds for which the airlines are guarantors. All of this had the result of placing the airlines in an inflexible financial position by increasing the amounts of certain types of fixed charges. For the U.S. scheduled airline industry, some $400 million in total interest payments, and in excess of $400 million in lease payments for aircraft, must be paid in both times of prosperity and times of recession.

U.S. airlines are already experiencing difficulty in financing their capital requirements, and, based on current indications, this problem will become more severe in the decade ahead. The financial community, upon which the airline industry is dependent for investments, has already expressed extreme reluctance to make additional investments.

AIRLINE CAPITAL REQUIREMENTS

Looking ahead for the next ten years, we foresee significant growth in airline traffic. Domestic revenue passenger miles are expected to increase from about 132 billion in 1975 to 235 billion in 1985. The number of domestic passengers boarding domestic trunk and regional airlines should reach 310 million by 1985, compared with about 188 million domestic passengers in 1975. The growth in freight traffic is expected to more than double over the next ten years. Obviously, significant increases in capital expenditures will be required to meet this public demand. Using conservative assumptions, we estimate the U.S. airline industry will require an additional $6 billion worth of aircraft and associated ground equipment between now and 1980. It has been estimated that the capital requirements between now and 1985 will approximate $20 billion.

This investment will be required not only to meet anticipated traffic demand, but also to secure more productive and efficient aircraft through constantly advancing technology. Such investments are important for achieving other goals and objectives, including those relating to fuel conservation, environmental considerations, and the most effective utilization of the nation's airport and airways system. For example, newer aircraft will be quieter, more fuel-efficient, and better sized to accommodate additional traffic with less impact on the airport and airways system.

Clearly, both the increasing public demand for air transportation, and the need for providing such transportation in the most efficient and economical manner, will require very heavy airline industry capital investment. The accomplishment of these goals depends upon the ability of the airline industry to attract the capital needed.

ACCUMULATED UNUSED INVESTMENT CREDITS

The investment credit was and is intended to encourage business investment by reducing the cost of capital equipment. However, the existence of unused and potentially unusable investment credits actually discourages new capital investment—a result exactly opposite to the stimulative effect sought. A taxpayer faced with expiring credits has an incentive to maximize short run profits in order to utilize expiring credits, rather than to make long-term capital investments for future growth.

Unless a taxpayer has some assurance that he will ultimately receive a benefit from his existing and new investment credits, he is likely to concentrate on using existing credits before generating new ones.

This problem of unused and expiring credits is of urgent concern to many businesses, large and small, which have made substantial equipment invest-

ments with the reasonable expectation of receiving the cash benefit of the credit, but which are now faced instead with expiring credits due to adverse economic conditions largely beyond their control. Loss companies and break-even companies need the benefit of the credit to reduce the cost of acquiring capital equipment just as profitable companies do. Most importantly, through their capital investments those less profitable companies contribute significantly to the stimulation of the national economy for which the investment credit provisions originally were enacted.

The problem of unused and expiring investment credits is particularly acute in the case of the airline industry which, as a result of erratic earnings over the past years, has large unused investment credit carryovers as shown in the following table:

UNUSED AIRLINE INVESTMENT CREDITS, AT DEC. 31, 1975

[In millions of dollars]

	Expiration dates						
Date generated	1976	1977	1978	1979	1980	1981	1982
Pre-1971 [1]	57.6	82.6	88.3	63.9	60.3		
Post-1970 [2]			47.9	95.7	91.0	65.3	127.2
Total	57.6	82.6	136.2	159.6	151.3	65.3	127.2
Grant total							779.8

[1] 10-yr carryovers.
[2] 7-yr carryovers.

Unless the investment credit program is corrected as proposed in S. 3080, substantially all of the airline credits expiring in 1976 will be lost in addition to the approximately $35 million that expired in 1975.

More ambitious proposals for refundability of unused investment credits have been made. In October, 1974, the Administration proposed refundability after a 3-year carryover period. Discussing the Administration's recommendations and the deficiency in the existing investment credit law, Assistant Secretary of the Treasury Frederic Hickman, on December 9, 1974, stated:

"Because of the income limitation, the credit offers no assistance at all to companies in financial difficulty and with no taxable income. Thus, *the companies for which increased productivity is the most critical get nothing at all,* and the government is constantly importuned to aid them in other ways, while their investment credits simply go down the drain." (Emphasis supplied.)

However, the Administration also proposed that the basis of the assets be reduced by the amount of the credit. When this was found unacceptable by the Congress and American businessmen, the Administration apparently not only abandoned basis adjustment but also ignored the plight of companies experiencing economic losses. There is no valid reason for conditioning refundability—which is designed to assist loss and break-even companies—upon a downward basis adjustment which would primarily increase taxes for profitable companies. Furthermore, basis adjustment, as it became effective, would increase revenues by many times the relatively modest cost of refundability.

More recently, Senator Kennedy proposed to this Committee full refundability of unused credits after the end of the year in which the credit is earned. The airlines would be in far better condition today if such a provision had been enacted in 1962 as part of the original investment credit. Unfortunately, Senator Kennedy's proposal would apply only to credits earned after 1976.

Whatever refund feature Congress decides to enact for credits earned in the future, we believe it is unfair to ignore expiring credits earned in the past. These credits were earned by investment in capital equipment, which the investment credit was designed to encourage. The nation obtained the benefit of the increased productivity and jobs that these investments provided. While the statute did not provide for refunds when these credits were earned, Congress never anticipated the problem of expiring credits which now faces the airlines and many other enterprises. In 1971, when Congress extended the carryover period from 7 years to 10 years for credits earned before 1971, the relief was applied to credits previously earned. Now history has demonstrated that the credit is still being

distributed unfairly and inefficiently. Refundability of previously earned credits is not simply a matter of equity. Refundability will remove the disincentive to invest created by the accumulation of unused and potentially unusable investment credits.

CONCLUSION

We strongly endorse the proposal contained in S. 3080, and respectfully request the Committee to give it early and favorable consideration. Enactment of this legislation will assure that the essential investment credit program will be usable by all companies with qualifying capital investments. It will also assist the airline industry in making the capital investments required in the future to continue to meet the demand for efficient air transportation and thereby contribute to the nation's economic strength.

Senator CURTIS. Mr. Barker, would you give your full name to the reporter and tell him in what capacity you appear and would the other two gentlemen do so also.

STATEMENT OF JAMES R. BARKER, OF MOORE-McCORMACK RESOURCES, INC., ON BEHALF OF AMERICAN INSTITUTE OF MERCHANT SHIPPING, ACCOMPANIED BY ERNEST F. CHRISTIAN AND ALFRED MASKIN, ON BEHALF OF THE AMERICAN MARITIME ASSOCIATION

Mr. BARKER. Mr. Chairman, I am James R. Barker. With me are Ernest Christian and Albert Maskins with the American Maritime Association. Mr. Christian is with us as tax counsel.

Senator CURTIS. You may proceed.

Mr. BARKER. I am testifying today on behalf of the American Institute of Merchant Shipping to urge an amendment to the legislation before you that would clarify that the investment tax credit is available for vessels purchased with capital construction fund withdrawals. Virtually every segment of the U.S. maritime industry—shipbuilding, ship operating, labor and management, companies in international trade and domestic trade, the Great Lakes maritime industry, and the fisheries—is in unanimous agreement on this issue.

Specifically supporting this statement are the American Maritime Association; Lake Carriers Association; Transportation Institute; Shipbuilders Council of America; Maritime Trade Department, AFL-CIO; Labor-Management Maritime Committee, Offshore Marine Services Association; Marine Engineers Beneficial Association, AFL-CIO; Sea-Land Service, Inc.; Matson Navigation Co.; Zapata Corp.; National Ocean Industries Association; and International Longshoremen's Association.

We thank you for the opportunity to present our views on an issue of great importance to the maritime industry.

In the interest of saving the committee's time and staying with the time limits requested, I will merely highlight the main points of our full written statement, copies of which have been filed with the committee.

With your permission, Mr. Chairman, I will make my statement and Mr. Christian will follow me with a short statement so we can answer your questions more fully.

The American merchant marine faces tremendous capital requirements over the next several years to meet recognized national needs.

According to the U.S. Maritime Administration between 1976 and 1983 the U.S.-flag merchant fleet will require over $7.6 billion of private investment.

Obtaining adequate private investment in the merchant fleet is important to the Nation. History has demonstrated, and the President and Congress have repeatedly recognized, that the U.S. merchant fleet is an indispensable defense asset, vital to national security. The Department of Defense considers both the fleet and a shipbuilding capability under U.S. sovereignty essential to the national interest. In our testimony today we urge you to remove an unintended obstacle to private investment in the U.S. merchant fleet which is frustrating an avowed national policy of revitalizing and rebuilding that fleet.

To maintain a merchant fleet in the interest of national security, and at less cost than the Government could own such a fleet directly, Congress has provided certain incentives. In 1970 a 10-year merchant shipbuilding program was initiated, one of the most important incentives of which was capital construction funds (CCF) under section 607 of the Merchant Marine Act.

As Mr. Christian will explain in more detail later, the CCF is a form of cost recovery, much like accelerated depreciation, pursuant to which the vessel owner or operator enters into an agreement with the Secretary of Commerce to establish reserve funds out of shipping income to build or purchase agreed upon ships. The CCF does not provide more than recovery of vessel cost since an operator who builds or purchases a vessel with capital construction funds must forego depreciation.

The Departments of Treasury and Commerce are jointly charged with administering capital construction funds. Since 1970 the Departments have been unable to agree over whether the investment tax credit is available for ships built with withdrawals from such funds.

The Department of Commerce and the industry have consistently maintained that the investment credit is available under existing law for CCF-built vessels. Treasury maintains that it is not available, at least in part on the technical grounds that the investment credit is only permitted for property on which depreciation is allowable.

We believe this position fails to take into account that the CCF is a form of cost recovery like accelerated depreciation which is taken in lieu of depreciation. It was never intended that the CCF be in lieu of the investment credit. Unfortunately, the language of existing law is somewhat unclear because when the present-day CCF was enacted in 1970, the investment credit was not in effect, having been repealed in 1969 and not reenacted until 1971.

The ambiguity is further demonstrated by the fact that litigation over the issue as it related to pre-1970 construction funds was settled between one taxpayer and IRS on a 50–50 basis. Other taxpayers have refused to settle and are proceeding with litigation, but that litigation is not likely to be dispositive of the issue with respect to post-1970 capital construction funds.

The Treasury's position on CCF creates an uncertainty which frustrates the national policy of rebuilding the merchant fleet by discouraging investment in ships. Since other forms of accelerated depreciation generally are permitted in conjunction with the investment

credit—as in the case of airplanes and railroad cars—denial of the investment credit for ships can result in an after-tax cost higher than the after-tax cost of such other transportation assets.

Another effect of discouraging investment in U.S. shipbuilding and ships is to export jobs and dollars. Shipbuilding is one of the most effective job-generating investments. Each $1 million of shipbuilding activity results in 44 jobs, one of the highest ratios in all manufacturing. Moreover, since 7 of 10 major shipyards are located in areas of chronic high unemployment, these jobs are provided where they are needed most.

In addition, Treasury's interpretation frustrates formation of employee stock option plans (ESOP) in the maritime industry since the extra investment credit incentive for ESOP is denied to U.S. shipping companies. My company, for one, intends to establish an ESOP as soon as clarifying legislation is enacted, and I think this is true of other companies, Mr. Chairman.

We urge the committee to end the uncertainty and clarify that the law permits the investment tax credit for ships built or purchased with withdrawals from capital construction funds. Earlier in this Congress the Senate passed maritime legislation—S. 1542—which would have amended the capital construction fund provisions of the Merchant Marine Act to accomplish that result.

Unfortunately, because of a jurisdictional question in the House, the matter was deleted in conference though the House conferees stated that they unanimously agreed with the merits of such legislation. We urge that the committee reaffirm that position as being in accord with tax equity and the national objective of rebuilding the U.S. merchant fleet.

Such action would be appropriate at this time and in the context of the bill before you. The tax reform bill amends the investment tax credit provisions of the Code to extend the credit. An amendment at this time clarifying the availability of the credit for vessels built or purchased with CCF withdrawals would be timely and germane. It is also urgently needed.

Thank you for your consideration.

Mr. Christian. Mr. Chairman and members of the committee, my name is Ernest S. Christian, Jr. I am a member of the law firm of Patton, Boggs & Blow and am tax counsel to the American Maritime Association, which consists of 37 companies operating 104 American-flag merchant ships in the foreign and domestic commerce of the United States. The executive director of that association, Mr. Alfred Maskin, is here with me today.

Capital investment is essential to economic growth and employment. The investment tax credit was designed to facilitate capital investment in job-producing machinery, equipment, and transportation facilities.

U.S.-flag merchant ships require enormous capital investment, are a source of substantial employment in otherwise high unemployment areas, play an important role in our national and international economy, and have long had a special relationship to our national defense.

Both tax and maritime policies dictate that U.S.-flag merchant ships should qualify for the investment tax credit the same as do railroad

cars, trucks, aircraft, all other transportation equipment, and indeed almost every kind of business equipment one can imagine. Clearly U.S.-flag merchant ships should not be the single significant item of capital equipment that is excluded from the investment tax credit that was designed to apply across the broad spectrum of the economy.

Nevertheless, U.S.-flag merchant ships constructed in U.S. shipyards with capital construction funds as expressly provided in the Merchant Marine Act of 1970 are now, as a practical matter, excluded from the investment tax credit. That incongruity arises solely from an interpretation of the statute by the Internal Revenue Service which is both incorrect and clearly contrary to the intent of Congress. The conference report on the Maritime Appropriation Authorization Act of 1975, adopted by the House and Senate, makes clear the intention that these ships qualify for the investment tax credit.

We urge this committee to enforce that intention with an amendment to the Internal Revenue Code to remove all doubt.

Under the Merchant Marine Act of 1970 a U.S. owner of a U.S.-flag merchant ship constructed in a U.S. shipyard and operated in the domestic or foreign commerce of the United States may enter into an agreement with the Secretary of Commerce to deposit agreed amounts of income from that ship in a reserve fund to replace that vessel, to construct or acquire an additional such vessel, or to pay the principal or indebtedness incurred in the construction or acquisition of such vessels. This fund remains under the supervision of the Secretary, may accumulate tax-deferred earnings, is dedicated to ships, and may be withdrawn without penalty only for the stated purpose.

When the shipowner makes a deposit in the fund, he takes an equivalent tax deduction which is balanced by a corresponding reduction in tax basis when the amount in the fund is withdrawn to purchase a qualified ship or pay qualified indebtedness on a ship. This means that the taxpayer's depreciation deductions—which he otherwise would be entitled to take—are either reduced or eliminated; just as when a taxpayer takes an accelerated depreciation deduction, the tax basis of the property is reduced and his future depreciation deductions are reduced or eliminated.

These provisions in the 1970 act for reduction of tax basis were carefully coordinated with the depreciation provisions of the Internal Revenue Code to achieve a directly comparable result. The "capital construction fund" is merely another method of cost recovery or accelerated depreciation. A significant difference is that a shipowner must actually set aside in a fund the amount deducted, whereas other taxpayers have full current use of the cash flow from depreciation deductions.

Although the Treasury has in other contexts expressed some reservations on the same point, recent regulations jointly proposed by the Treasury and the Maritime Administration characterize the reduction in basis under the "capital construction fund" method of cost recovery, as follows:

". . . [A]ny reduction in basis . . . shall be treated as an adjustment reflected in adjusted basis on account of deductions for depreciation within the meaning of section 1245(a)(2) . . ."

It is axiomatic that the investment tax credit applies to the full cost of property even though that cost may be fully deducted against income—and the tax basis reduced to zero—within a relatively short time. Thus, the investment tax credit should be equally applicable whether deductions are taken by the capital construction method of cost recovery or some other accelerated method of depreciation such as is applicable to all other property eligible for the investment tax credit.

Being directly comparable to accelerated depreciation, the "capital construction fund" method does accelerate cost recovery, but that is no reason to deny the investment tax credit. In the case of other property which is unquestionably allowed the credit, under the ADR system there may also be very substantial acceleration of cost recovery compared to some hypothetical standard such as "useful life."

The cost of any property is 100 percent of what is paid for it, but it is also possible to determine so-called after-tax cost by computing the present value of the future deductions of that cost. Comparisons of after-tax costs are instructive.

Under ADR after-tax cost for an aircraft is 61 percent and for a railroad car is 65 percent. In the case of ships, under the "capital construction fund" method most typically after-tax cost is about 60 percent depending on how the ship is financed, although it is hypothetically possible for after-tax cost to be 52 percent.

Thus, the precredit after-tax costs of aircraft, railroad cars, and ships are similar, but aircraft and railroad cars get the investment tax credit and U.S.-flag merchant ships constructed with capital construction funds do not.

There is plenty of economic justification for applying the investment tax credit to U.S.-flag merchant ships, as other testimony has shown. But the U.S.-flag merchant fleet should not be singled out and made the only industry which is required particularly to justify receiving the investment tax credit. In the history of the credit it has never been considered possible or necessary to quantify precisely the amount of increased investment or employment that results.

Instead, there have been three basic principles. First, that through the interaction of all elements of the economy the credit would have a substantial effect even though not precisely quantifiable; second, that the credit should, therefore, be available as broadly as possible to all kinds of machinery, equipment and transportation facilities; and, third, that the credit should essentially be neutral as between different kinds of capital investments.

This essential neutrality of the credit is important. Obviously, the credit is a significant reduction in capital cost and an increase in the after-tax rate of return to investment. To the extent that some machinery, equipment, and transportation facilities get the credit and others do not, a substantial bias is created in the economy. Investments left out are penalized. After-tax rate of return on investment is reduced and the flow of investment capital into that sector of the economy is diminished relative to others.

If any bias is created, it should be in favor of, not against, capital investment in the U.S.-flag merchant fleet.

I thank the committee for its attention.

[The proposed amendment to H.R. 10612 follows:]

PROPOSED AMENDMENT TO H.R. 10612

Add to title VIII a new Sec. 803 (beginning after line 30 on page 168) as follows:

"SEC. 803. CAPITAL CONSTRUCTION FUNDS.

(a) *Capital Construction Funds.* Section 46 of the Internal Revenue Code of 1954 is amended by inserting at the end thereof the following new subsection:

"(g) *Capital Construction Funds.* Notwithstanding any other provision of law, a vessel (and a barge or container which is part of the complement of such vessel) shall not fail or cease to be section 38 property, nor shall the amount of qualified investment (determined under sections (c) and (d)) or the amount of credit allowed by section 8 be reduced, because of any deposit in or qualified withdrawal from a capital construction fund established under section 21 of the Merchant Marine Act of 1970 (46 U.S.C. 1177) or because of any reduction in basis required thereunder. This subpart shall be applied by treating any such reduction in basis as resulting from the allowance for depreciation under section 167. For purposes of this subpart, the actual useful life of such property shall be treated as the useful life for computing depreciation."

(b) *Effective Date.* The amendment made by subsection (a) shall apply to taxable years beginning after December 1, 1969, and to the amount of credit allowed by section 38 of the Internal Revenue Code of 1954 for such taxable years."

The CHAIRMAN (presiding). I have read both statements. We are going to help you with this matter if we can.

Democracy is like a liferaft. It won't sink, but you will always have your feet wet and there will always be some idiot standing on the wrong side holding his end underwater.

In 1970 we proclaimed the proud purpose in working with the industry with a Republican President and a Democratic Congress, we were going to put the merchant marine back on its feet again, and then what we did was undone by the Treasury Department.

We passed through the Senate what you are asking us to pass now. The Ways and Means Committee said they must have jurisdiction. I hope you will try to educate them before we get there, because it is slow, hard work and we will do what we can to educate them as to the purpose of this law to begin with, that it was not to deny you tax credit, but it was to give you this addition to the tax credit because you needed it.

That was the whole purpose of the 1970 act. As I understand what you are saying here, you don't get as much advantage out of the mix from the investment tax credit as the railroads do, who do not need a special act to subsidize them.

I think I understand your problem. I have been around here for a while. I was here when the whole misinterpretation started. Thank you very much.

[The prepared statement of Mr. Barker and a letter from the Shipbuilders Council of America, follows:]

STATEMENT OF JAMES R. BARKER

Mr. Chairman, members of the committee, I am James R. Barker, chairman of the board of Moore-McCormack Resources, Inc. I am speaking on behalf of the American Institute of Merchant Shipping in favor of legislation which would clarify that existing law makes the investment tax credit available to capital construction fund withdrawals, and resolve a longstanding administrative dispute between the Departments of Commerce and Treasury. Virtually every segment of the U.S.-flag merchant marine: Shipbuilding, ship operating, labor and management, companies in international trade and domestic trade, the Great Lakes maritime industry, and the fisheries, are in unanimous agreement on this issue. Specifically supporting this statement are the American Maritime Associa-

tion, Lake Carriers Association, Transportation Institute, Shipbuilders Council of America, Maritime Department, AFL-CIO, Labor-Management Maritime Committee, Offshore Marine Services Association, Marine Engineers Beneficial Association, AFL-CIO, Sea-Land Service, Inc., Matson Navigation Company, Zapata Corp., National Ocean Industries Association, and International Longshoremen's Association.

SUMMARY AND CONCLUSION

The American merchant marine faces tremendous capital requirements over the next several years to meet recognized national needs.

History has demonstrated, and the executive branch and Congress have repeatedly recognized, that the U.S. merchant fleet is an indispensible defense asset, vital to national security.

To maintain a merchant fleet in the interest of national security, and at less cost than the Government could own such a fleet directly, Congress has provided certain incentives.

In 1970, a 10-year merchant ship building program was initiated, one of the most important incentives of which was Capital Construction Funds (CCF) under section 607 of the Merchant Marine Act.

The CCF is a form of cost recovery, much like accelerated depreciation, pursuant to which the vessel owner or operator enters an agreement with the Secretary of Commerce to establish reserve funds out of shipping income to build or purchase agreed upon ships.

The Departments of Treasury and Commerce are jointly charged with administering capital construction funds and with issuing joint regulations. Since the agencies continue to disagree over whether the investment tax credit is available for ships built with withdrawals from such funds, the joint regulations which were published after a delay of 5 years still do not address the issue.

The Department of Commerce, and the industry, have consistently maintained that the investment credit is available under existing law for CCF-built vessels and Treasury maintains that it is not. The full Senate, and House maritime leaders have agreed with the Commerce Department in construing the Merchant Marine Act.

The Treasury's position on CCF creates an uncertainty which frustrates the national policy of rebuilding the merchant marine by discouraging investment. Since other forms of accelerated depreciation generally are permitted in conjunction with the investment credit, denial of the investment credit for the ships can result in their after-tax cost being higher than the after-tax cost of other transportation assets, creating a disincentive to investment in ships.

Another effect of discouraging investment in U.S. shipbuilding and ships is to export jobs and dollars.

We urge that the Committee end the uncertainty and clarify that the law permits the investment tax credit for ships built or purchased with withdrawals from capital construction funds. Such action would not result in a revenue loss or tax expenditure. Moreover, it would be in accord with the national objective of rebuilding the U.S. merchant fleet.

CAPITAL NEEDS OF THE MARITIME INDUSTRY

We are appearing before you at a critical juncture for the U.S. merchant marine. Since 1970 the industry has been actively responding to the challenge presented by the Merchant Marine Act of 1970. We have reversed the decline in tonnage and in percentage of the U.S. foreign commerce carried by the U.S. fleet. The U.S. merchant marine has been responsible for the development of revolutionary changes in ship design and cargo handling—innovations the rest of the world is now copying.

As the rest of the world adapts to these changes, the U.S. fleet requires ever increasing investment just to stay even. And the replacements cost enormously more than the vessels they are replacing. A conventional cargo vessel built during the 1960's cost about $10 million. A new container vessel, while much more productive, costs $50 to $60 million—and other innovative vessels may be even higher.

The industry is now faced with enormous capital requirements, of a magnitude even greater than in the past several years. According to the Maritime Administration, between 1976 and 1983 the U.S.-flag merchant marine in the foreign and domestic deepsea commerce is going to require over $7.6 billion of private

investment capital. This $7.6 billion represents the need for capital to replace obsolete vessels with modern competitive vessels, and represents a very small but nonetheless ascertainable possible increase in both the liner segment and the bulk carriage segment of the U.S. foreign trade. The United States presently carries only 6½% of the total tonnage in the U.S. foreign trade, representing approximately 19% of the total value of imports and exports in the U.S. trades. This $7.6 billion figure for the next seven years contrasts with an estimated $5 billion of current total private investment, excluding vessels under construction. Obviously, the capital requirements of the industry in relationship to the industry's size are immense.

The capital requirements of the industry will have to be met despite rates of return on investment lower than simple interest available in bank accounts. The liner cargo segment of the industry, in which the U.S. has by far the greatest market penetration, earned an average return on investment for the years 1970–1973 of only 3.6%.

THE MERCHANT MARINE IS IMPORTANT TO NATIONAL SECURITY

The need to maintain and, hopefully, increase the carrying capability of the U.S. merchant marine is an important national concern. In two World Wars, Korea and, most recently, Vietnam where merchant vessels carried 97% of U.S. supplies, the merchant marine has served as an indispensible defense asset. Between the end of World War II and 1970, however, the merchant marine declined to the point where it was dangerously antiquated.

In 1970, Congress, with strong Administration support, proclaimed a national objective of rebuilding and revitalizing the merchant marine, including a 10-year ship construction program. Today, mid-way through the 10-year building program, the privately owned U.S. merchant marine stands at a level of 509 vessels. This fleet, much of it with mandated national defense construction features, supplements the Navy's fighting and general purpose fleet of 482 vessels in constituting overall U.S. seapower. It is recognized by virtually all concerned, including the Defense Department, that this level is only marginally adequate.

The importance of the merchant marine, and the validity of the national policy of maintaining an adequate fleet has been most recently analyzed and affirmed in the oversight hearings being held this year by the House Merchant Marine and Fisheries Committee. The first witness in these hearings, which are being held at the midpoint of the 1970 maritime program, was Dr. John J. Bennett, Acting Assistant Secretary of Defense for Installations and Logistics. Dr. Bennett stated:

"I cannot overemphasize that the Department of Defense supports and needs a viable U.S.-flag merchant marine in peace and war. History books are full of references to the direct role played by U.S.-flag merchant vessels in support of American forces overseas in time of war. In a major war, Defense would be almost entirely reliant on civilian shipping assets. In peacetime, the need is no less great, where the vast preponderance of our defense cargo moves in U.S.-flag vessels, much of it in berth line service, side by side with the freight of U.S. commerce. Indeed, a vital segment of the defense materiel distribution system is in the hands of the U.S.-flag maritime industry—in peace and war."

Dr. Bennett went on to characterize the U.S.-flag merchant marine as the fourth arm of our national defense effort, and to state that the Department of Defense considers a shipbuilding capability under U.S. sovereignty essential, and one that must be maintained in the national interest.

Other witnesses in the hearings have noted that it is not at all difficult to foresee a situation in which only U.S.-flag vessels would be available to supply our allies, for example in a Middle Eastern conflict.

Many of the witnesses at the oversight hearings have also emphasized the need for a strong maritime industry in this era of increasing political nationalism, with many third world countries and even allies taking economic action for national political and economic motivations. The oil embargo of 1973 and 1974 is the strongest example of that, however in the maritime industry we have many other significant, although less drastic, examples of economic nationalism. Some nations have imposed 50%, and even 100% requirements of carriage of their cargo on national flag vessels. Further, Communist-bloc nations have clearly recognized the importance of a national merchant marine, and have invested very

heavily in building their own. The Soviet Union from 1965 to 1975 nearly doubled their fleet from 9 and a half million dwt to 17 and a half million, while the U.S. fleet declined slightly. The Soviets only six years ago had virtually no vessels in third flag trades and are now an important liner carrier in the U.S. trades, with expansion plans indicating another doubling of their fleet.

CONGRESSIONAL PROGRAMS TO SUPPORT THE U.S.-FLAG

Congress has long recognized and been committed to maintaining a strong merchant marine as a vital element in protecting national security.

The Congressional program in the 1970 Merchant Marine Act is based on a recognition of the need for a viable U.S.-flag merchant marine, one vital to our military and economic well-being. It recognized that achievement of these goals would require an important Federal commitment to the merchant marine. Without this Federal program, the important needs to be served by this industry simply will not be met. Congress also recognized that there are, fundamentally, two possible ways of performing the necessary tasks. The government could, if it wished, build its own fleet and man that fleet on a stand-by basis with crews paid by the government directly. Congress has chosen the alternative, however, of enabling U.S. built and operated vessels to compete with foreign flag vessels. The government has, we think quite sensibly, concluded that it is far cheaper to carry out its maritime policies through a private merchant marine operating in commercial markets and under commercial constraints than to undertake development of its own proprietary fleet.

The effect of that policy is to require that the U.S.-flag fleet compete in the capital market for investment in U.S.-flag vessels. One of the methods through which Congress attempted to assure that there would be adequate investment in U.S.-flag vessels is through § 607 of the Merchant Marine Act, the Capital Construction Fund.

As Mr. Christian will explain in more detail later, the Capital Construction Fund is best understood as a form of accelerated depreciation. In some instances, though not necessarily all, it may be more accelerated than some of the schedules provided in the code. However, to offset what may be a slightly faster rate of cost recovery, it 1) is limited to shipping income, unlike depreciation which can be used as an offset against other kinds of income and 2) the amounts taken as a deduction must be placed in an actual fund to build ships pursuant to an agreement with the Secretary of Commerce.

DIFFERING ADMINISTRATIVE INTERPRETATIONS

The Department of the Treasury and the Department of Commerce are jointly charged by the Merchant Marine Act with responsibility for administration of the Capital Construction Funds. The Treasury Department and the Commerce Department are directed to issue joint regulations for the operation of funds. The promulgation of the joint regulations was delayed for over five years. The reason for the delay was primarily a difference of opinion between the Departments of Commerce and Treasury as to the effect of the use of qualified withdrawals from Capital Construction Funds on the availability of the Investment Tax Credit. The regulations which were finally published on *February 10, 1976*, still do not address this issue, because of the continuing differences of opinion between Treasury and Commerce. Treasury asserts the view that any vessel operator which purchases or amortizes a vessel with qualified withdrawals from a Capital Construction Fund must forego the Investment Tax Credit to the extent of those withdrawals. We believe that this interpretation contravenes the legislative history, the language of the Internal Revenue Code, and has had the effect of discouraging the construction of U.S.-flag vessels in the United States. It results in frustration of Congressional policy, disincentive to investment in U.S.-flag vessels, and the export of jobs both in vessel construction and operation. We do not think that the Treasury position on the Capital Construction Fund makes sense, either as maritime policy or as tax policy.

Since other methods of accelerated depreciation are permitted in connection with the Investment Tax Credit, we feel that to deny it in this instance would be discriminatory against the U.S. merchant marine. Indeed, as Mr. Christian will later explain, if the investment credit were to be denied for vessels in this instance, the after tax cost of purchasing or building a vessel could be significantly higher than the after-tax cost of purchasing an airplane or railroad car.

EXPORT OF JOBS AND DOLLARS

The disincentive to investment in U.S. built U.S.-flag ships also has serious and substantial economic effects. Approximately 8% of total U.S. steel production is utilized in shipbuilding. Moreover, ship building is a labor intensive industry producing 44 man-years of employment per $1 million of contracts, one of the highest ratios in all manufacturing. Further, seven of the ten major U.S. shipyards are located in chronically high unemployment areas. Department of Labor statistics show that 27.9% of shipyard workers are minority group members, including 23.2% who are black.

Many American companies, however, choose to invest their capital in construction of vessels outside of the United States either directly or through foreign affiliates. One purpose of the Capital Construction Fund was to encourage construction of these vessels in the United States, not only to encourage employment, but to aid the U.S. balance of payments as well. The following table shows the construction in the years 1972, 1973 and 1974 of vessels in foreign shipyards only for U.S. corporations and their affiliates:

	Number of vessels constructed for U.S. companies in foreign yards for foreign registry	Shipbuilding dollar contract value to foreign yards (millions)	Man-years of employment in United States if vessels had been constructed in United States under 1970 act program
1972	66	$1,275	98,428
1973	28	780	58,158
1974	61	2,025	146,080
Total	155	4,080	302,676

While not all of this construction is likely to be transferred to the United States, even relatively nominal shifts would generate substantial employment, not to mention tax, balance of payments, and welfare savings benefits to the U.S. economy as follows:

Amount of transfer:	*Additional man-years of employment*
5 percent	15,000
10 percent	30,000
15 percent	45,000

The Department of Treasury position results in substantial uncertainty as to the status of any investment in a U.S.-flag vessel built with a qualified withdrawal from a Capital Construction Fund. May of these vessels are built on long term fixed price carriage contracts for which a rate of return on investment must be calculated in advance. Moreover the possible denial of the Investment Tax Credit could in marginal cases cause a company to decide to build foreign, or could result in a rate quotation from a U.S.-flag carrier that is noncompetitive with foreign built or foreign registry rates. Vessels built for U.S. registry are eligible for the Investment Tax Credit even if built abroad. Absence of the ITC on a vessel constructed with a Capital Construction Fund in U.S. shipyards could make the difference in a choice between building in American or foreign shipyards. Important national goals enunciated over and over again by Congress would be frustrated. What the proposed legislation would entail is a clarification of a disputed position between two administrative departments by adoption of the interpretation which will effectuate a clearly enunciated Congressional purpose.

I would like to add at this point that not all construction of U.S.-flag vessels would be affected by this legislation. At present there are 96 funds containing $296.1 million.

THIS LEGISLATION IS NOT AN EXTENSION OF THE CCF OR THE ITC

We would emphasize to the Committee that we are requesting neither an extension of the Investment Tax Credit nor of the Capital Construction Fund.

We simply ask for a clarification of what we believe to be existing law. We are not alone in the view that existing law permits the Investment Tax Credit for vessels built with qualified withdrawals from Capital Construction Funds. This has been the consistent position of the Department of Commerce for at least four years. That Department has joint responsibility with IRS for administering Capital Construction Funds. Further, the Senate Committee on Commerce as well as House and Senate maritime conferees have expressed the view that the Commerce Department is correct and in accord with Federal maritime policy.

We believe that the Commerce Department-Industry position is fair, consistent with tax policy, and important in realizing national maritime policies. We hope you will concur.

SHIPBUILDERS COUNCIL OF AMERICA,
Washington, D.C., April 1, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The purpose of this letter is to endorse and support testimony given before the Committee on Finance on March 31, 1976, by James R. Barker, Board Chairman, Moore-McCormack Resources, Inc. (on behalf of the American Institute of Merchant Shipping), and Ernest S. Christian, Jr., Tax Counsel, the American Maritime Association, proposing legislative clarification of the applicability of investment tax credit (ITC) to qualified withdrawals from Capital Construction Funds (CCF) authorized by the Merchant Marine Act of 1970.

Composed of major shipbuilders and ship component suppliers in all sections of the country, the Shipbuilders Council of America views the availability of ITC as an important factor in the equation which will influence the construction of merchant ships, under the CCF provisions of the 1970 Act, in American shipyards by American craftsmen with American products for American citizens.

Within the past two years, world shipbuilding has suffered the trauma of steadily declining prospects, primarily as a result of a global shipping recession and the by-products of the 1973 Middle East oil embargo. The spector of idle shipbuilding capacity and shipyard unemployment in all principal shipbuilding countries is today drawing urgent attention. Government responses are expected to expand direct and indirect forms of assistance, including tax devices, to shipbuilders as well as shipowners as a means of encouraging shipbuilding and of avoiding the burdensome public costs of unemployment.

On the basis of present production and delivery schedules, only seven merchant ships will be on order in American shipyards at the end of 1978—in shipbuilding terms, because of the long lead time involved, that is tomorrow! In the year 1975, 12 new merchant ships of 1,000 gross tons and over have been ordered from American yards. At the same time, 12 have been cancelled for a net gain of zero! In point of fact, no new contracts coming within the present construction subsidy program have been added to the U.S. merchant shipbuilding orderbook since June 30, 1974. And, contrary to the prevailing impression and earlier forecasts, prospects for additional contracts are scarce at this moment.

Under these circumstances, employment in that portion of the U.S. shipbuilding industry devoted to the construction of merchant ships will begin to drop sharply by mid-1977—perhaps earlier. Without new orders promptly these shipyards, many of which are located in areas of chronic unemployment, will face an uncertain future. The consequences in real terms of retaining skilled workers, operational stability, utilization of new facilities, procurements from supporting industries and services, fiscal solvency and tax revenues plus offsetting unemployment compensation payments and social expenditures by the public treasury could be significant.

Adoption of the proposal advanced by Messrs. Barker and Christian could provide a helpful deterrent to these consequences and a desirable stimulus to needed shipbuilding contracts. We hope it will merit the Committee's approval and that this letter, reflecting the position of our membership, can be made a part of your March 31, 1976 hearing.

With best personal regards, I am
Cordially,

EDWIN M. HOOD, *President.*

The CHAIRMAN. Next we will call Mr. Robert M. Drevs, chairman and chief executive officer, Peoples Gas Co., on behalf of the American Gas Association.

STATEMENT OF ROBERT M. DREVS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PEOPLES GAS CO., ON BEHALF OF THE AMERICAN GAS ASSOCIATION

Mr. DREVS. Thank you, Mr. Chairman.

As you pointed out, I am Robert M. Drevs, chairman and chief executive officer, Peoples Gas Co., appearing on behalf of the American Gas Association. Accompanying me is Mr. Joseph M. Wells, vice president and general counsel of Peoples Gas Co., and also with me is Charles W. Davis of Chicago, Ill., our tax counsel.

The CHAIRMAN. I thought he was a former member of the Ways and Means Committee staff.

Mr. DAVIS. Thank you, Mr. Chairman, it is nice of you to remember.

Mr. DREVS. The purpose of my testimony is to provide you and the members of the committee with background information on the capital needs of the gas industry. Hopefully we can assist you in this way in considering and formulating tax legislation which will foster the growth necessary to enable our industry to raise its needed capital.

Since about 1970, the absolute volume of proven gas reserves has been declining.

In 1975, despite a growing concern over energy supplies, only 11 Tcf—trillion cubic feet—of natural gas were added to U.S. reserves, compared to 1975 production of 20 Tcf, a net reduction in reserves of 19 Tcf.

Fortunately, our winter weather this year was much warmer than normal on a nationwide basis. For example, in Chicago we are experiencing one of the warmest winters in over 40 years, being 9 percent warmer than normal. The country thus avoided the spectacle of plant closings and resultant job losses. However, this happy fact did not solve our basic problem: It only gave us a modest breathing spell to work on its solution.

Substantial gas reserves do remain to be found and developed, but the precise quantities of unfound natural gas can only be determined by drilling. The easily available gas has been found. Not only are new fields harder to find, but wells must now be drilled 20,000 to 30,000 feet deep at costs per well in excess of $5 million.

The Energy Research and Development Administration has presented strong arguments for emphasizing the continued development of gas and other traditional domestic energy resources. It concludes that for the short term—1975–85—the Nation's immediate energy needs must basically be met with existing energy systems.

Natural gas presents particularly attractive opportunities for increased production, both from traditional and from synthetic gas sources. Compared with electricity, natural gas requires only one-fifth and synthetic gas two-fifths the dollar investment per Btu of energy produced.

The gas industry's program for meeting the needs of its market is generally consistent with that proposed by ERDA. Incremental sup-

plies for the next 5 years in our judgment must come from the lower 48 States and the Gulf of Mexico.

Gas from so-called traditional sources must, of course, be supplemented. Gas industry members are presently involved in the development of at least four large-scale coal gasification projects using existing technology and western coal.

Our own experience at Peoples Gas system indicates that complexes, which are capable of delivering 250 million cubic feet per day of synthetic gas from coal, cost in excess of $1 billion each. Thus, to produce gas equal to 5 percent of our peak day deliverability we must increase our assets by 45 percent.

The gas industry is also hard at work to bring Alaskan gas to the lower 48 States. There are currently two such projects which are involved in a proceeding before the Federal Power Commission. Whichever of these two projects is approved, the cost will be approximately $10 billion at the time of completion.

The gas industry has already constructed and has in operation plants which produce synthetic gas from liquid petroleum feedstocks. Our system has just put onstream such a plant which produces approximately 160 million cubic feet of gas per day and which was constructed at the cost of $100 million.

In addition, industry members have a number of projects in varying stages of development for the importation of liquefied natural gas from foreign sources. These LNG schemes require enormous amounts of capital to finance liquefaction facilities at the foreign source, especially designed cryogenic tankers and the construction of storage and gasification facilities in this country.

CAPITAL REQUIREMENTS

Investments by the natural gas industry for the next decade are estimated by several sources at $90 to $100 billion.

Previously, interstate pipelines depended upon independent producers almost exclusively to develop new gas supplies. However, with deliverability from, and reserve additions to, traditional supplies falling off, and with continued regulation which requires producers to charge far less than the economic value of natural gas sold in interstate commerce, pipelines have had to make interest-free advance payments to producers and equity investments in order to get gas.

This has, of course, substantially increased the cash requirements of the natural gas industry and at the same time made more difficult the problem of raising the necessary capital. In the future, the industry faces far larger capital commitments for coal gasification, Arctic gas, SNG and LNG projects.

The gas industry, however, just doesn't have the capital-raising ability to finance such supply projects without legislative and regulatory assistance. For example, over the next 10 years Peoples projects additional investments of $6.7 billion, if it is to just maintain current deliveries. That compares with present book assets of $2.2 billion. In a single decade we propose to triple the present investment accumulated over the 120 years of our existence just to serve currently attached load. Other gas companies are in the same situation.

We are advised by our investment bankers that we will not be able, without assistance, to raise in the capital markets the required amount of capital for the projects we believe we should undertake. That is an unfortunate fact in a capitalistic economy. It is attributable to a combination of factors, including:

(1) Resistance to adequate and timely increases in the rates we can charge our customers. Unless customers pay the cost of the service we provide, the gas industry cannot exist—much less grow.

(2) The necessity to make enormous investments in new technologies where the economics are as yet unproven. This is further compounded by the existence of very long lead times, before millions of dollars of investments become productive.

(3) The indecision and uncertainty as to government energy policy, which increases investor uncertainty.

Historically, the natural gas industry has had to raise about 70 percent of its capital from external sources. Huge industry capital requirements of the future will exert further upward pressure on this percentage. Therefore, capital formation is going to be a major concern of the industry for years to come.

We strongly urge that the industry needs economic incentives, including revisions of the tax laws, which will permit adequate cash generation.

GAS MUST NOT BE PENALIZED IN COMPARISON WITH ELECTRICITY

We are well aware of the administration's proposals, based on recommendations of the President's Labor-Management Committee, to benefit the electric industry with certain tax relief measures. These were presented to this committee by Secretary Simon in his March 17 testimony. To my knowledge the comparable and even greater problems of the gas industry were not considered by the President's committee.

I would point out to you that if you benefit just one segment of the utility industry, you will make it more difficult for the remainder of the industry to raise the required capital from the same class of investors. Thus you rob Peter to pay Paul.

The gas industry has capital requirements proportionately equal to the electric industry during the next ten years. In addition, gas company senior securities have very large sinking fund requirements which must be met in the next decade.

The capital problems of the gas industry are every bit as great as those of the electric industry and would be worsened if gas companies should not be eligible for any assistance extended to the electric industry.

Recommendations: As to specific suggestions for consideration by the Senate Finance Committee, the generation of internal and external capital could be substantially improved by:

1. Increasing the investment tax credit to 12 percent on a permanent basis;
2. Providing a concurrent investment tax credit on construction work in progress;
3. Providing for faster amortization through increased depreciation rates for nontraditional and existing facilities;

4. Permitting immediate amortization of construction work in progress;
5. Providing, with respect to any changes in the tax laws, that the benefits must be retained by the utility and that regulatory agencies may not require that such benefits be passed through to its customers;
6. Encouraging the purchase of common and preferred stocks of energy utility companies by providing for tax deferral on dividends reinvested in the utility paying the dividend; and
7. Defining "utility" broadly enough so that tax legislation will encompass all phases of the natural gas industry—production, transmission, distribution and storage, including a holding company.

In summary, it is urgent that the United States develop priorities to meet the overall energy goals of increasing domestic energy production and providing capital for an energy program. The gas industry plays, and must continue to play, a major energy role. The specific recommendations I have made here will help the entire economy, and in particular capital-intensive industries.

The CHAIRMAN. Thank you very much.

Senator Curtis?

Senator CURTIS. How does your industry differ from the electric industry in the service that it renders to our economy?

Mr. DREVS. The electric industry is a converter of energy and we are a basic supplier industry. The electric industry must take gas, oil, coal, nuclear fuel and convert it into a form of energy which it merchandises or provides. We are one of the providers of a basic form of energy.

Senator CURTIS. As far as the wheels of American industry are concerned, you both supply the same product?

Mr. DREVS. We both supply it but our industry supplies it more economically.

Senator CURTIS. Do you receive the same tax treatment in reference to capital accumulation as does the electric industry?

Mr. DREVS. At the present time; yes, sir.

Senator CURTIS. How do the two industries compare in the treatment received in the House bill that is pending before the committee?

Mr. DREVS. I believe it is the same.

Senator CURTIS. Does the House bill contain a special feature in the investment credit for electric energy?

Mr. DREVS. No, sir, it does not, not to my knowledge, and counsel advises me it does not.

Senator CURTIS. How do the two industries compare in the Treasury recommendations?

Mr. DREVS. In consultation with the staff of Treasury, it is their view the gas industry should be getting the same treatment as the electric industry.

Senator CURTIS. What has the Treasury recommended?

Mr. DREVS. May I ask Mr. Davis to respond to that? It is a technical question which he can answer better than I can.

Senator CURTIS. Did the Treasury make a special request with respect to the investment credit, as it applies to utilities?

Mr. DAVIS. Yes.

Senator CURTIS. What was that request?

Mr. DAVIS. There is a 6-point program set forth in the testimony of Secretary Simon. The first is to increase the investment tax credit to 12 percent and to give immediate effect to a provision of the Tax Reduction Act of 1975 with respect to immediate tax credit on progress payments of construction.

The Treasury further suggests permission for electric utilities to begin depreciation of major construction projects during the construction period. Property, as you know, is not depreciable until the point at which it is placed in service under the existing law. This would permit depreciation to begin as the payments are made.

Then there is a special provision for pollution control equipment and also for the costs of converting an electric power generating facility that is using a petroleum product.

Finally, Treasury would postpone the tax on dividends paid by a utility on its common stock, which would enable people to elect to take additional common stock tax free rather than receive the cash.

There is no strict conformity between the recommendations of the American Gas Association as enunciated here by Mr. Drevs and the Treasury proposals. I think the basic point is whatever is deemed by this committee to be deserving of change for the electrical industry, it should also be equally available for the gas industry.

Senator CURTIS. Were those recommendations of the Treasury applicable to the electrical energy to over and above what they were recommending for industry generally?

Mr. DAVIS. Yes.

Senator CURTIS. Is the burden of your testimony that, insofar as is practical, your industry would request the same treatment that is accorded to the electric companies?

Mr. DAVIS. Yes, sir.

Senator CURTIS. Mr. Drevs, is your company both a producer and a distributor?

Mr. DREVS. We produce only about 5 percent of our supplies and the rest we purchase. Our system is an integrated system and we produce about 5 percent.

Senator CURTIS. Does the American Gas Association represent producers, distributors, or both?

Mr. DREVS. Generally transmitters and distributors rather than producers. Producers are represented by a different association, sir.

Senator CURTIS. Where is the heaviest capital need, in the production or distribution of natural gas?

Mr. DREVS. At the moment I would say it is probably in the production end, although once the gas is found, it requires very substantial investments by the transmission segment of our business to bring the gas in, most of which is found on the gulf coast, and we must build the facilities to get the gas in to shore and get it to the markets.

A second factor is that because the natural gas reserves are dwindling as rapidly as I pointed out, we will have to go to producing synthetic natural gas and coal from oil or from other sources, or bring gas in from foreign sources or down from Alaska. So there will be very substantial investments by the distribution systems in the future. Many of them are now making those investments.

Senator CURTIS. About a year ago I visited South Africa, and they are way ahead of us in their energy matters. They have been producing

gasoline out of coal. Some subsidy was needed initially. Now, it is operating without a subsidy.

They are in the process of enlarging the capacity of their production of gasoline from coal to the point where, if a worldwide crisis were to occur, they can run their essential industries on the gasoline they produce there from coal.

I certainly think that this is a field that this country ought to pay some attention to.

Mr. DREVS. I might point out in South Africa there is also a plant that produces natural gas from coal. We are very familiar with the process. Some of our people have been over there to review the process and we are presently designing a plant to produce natural gas similar to the process being used in South Africa and a similar pilot-type plant in Scotland.

We are familiar with them and we are watching them very closely.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. This process you speak of has been used for more than 50 years. I can remember in my little town in Arizona we used the process long before we had natural gas. Have there been many changes in that process?

With modern technology have we improved that to any great extent?

Mr. DREVS. The SNG process has been improved and modified so it can produce gas of a higher Btu, so we can produce what we in the industry call "pipeline-quality gas" which has similar properties to natural gas. There are a number of other processes under development.

Senator FANNIN. I am sorry I was not here to hear your complete statement. Does this figure of $90 billion include projects that have been talked about, the coal gasification plants?

Mr. DREVS. It includes some of them. Some of them have been laid out at the specific time. I am sure it will not include all the needs of the next 5 to 10 years.

Senator FANNIN. You are talking about the plants over the years?

Mr. DREVS. Yes.

Senator FANNIN. Would this $90 billion include three or four?

Mr. DREVS. It includes at least the four and maybe more. I am familiar with at least four.

Senator FANNIN. If we are to be of assistance to you as far as the tax measures are concerned and as far as working out the different problems that you have, it seems to me that we must do something that will help from the standpoint of the regulatory industry and the States, which seems to be the barrier which prevents you from accumulating capital. It is something which is cumulative.

Tucson Gas & Electric practically had to declare bankruptcy before they could get any relief. Is there any way the Congress can—I don't want them to take over any States rights, but I do realize the tremendous problem that exists. These regulatory bodies—we have enough problems with them here in the Capitol, but around the States there are problems with them too. Is there anything along that line that might be considered by this committee?

Mr. DREVS. We would agree that the State agencies should not be taken over by the Federal Government because of the problems they have. We would certainly suggest it would be in order for the Federal

Government to recommend to the State agencies the need for higher rates so the energy problem can be solved because the energy problem is a national problem and a recommendation from the Federal Government or a prestigious body like your committee would certainly go a long way in bringing it to their attention.

Senator FANNIN. It is interstate commerce and it falls within our jurisdiction.

Mr. DREVS. I would suggest you do have the power. With the Federal Power Commission regulating the transmission of gas, a recommendation along the lines you are suggesting would certainly be appropriate because their rate decisions have not provided an adequate return.

Senator FANNIN. I realize the tremendous problems you are having.

As far as the EPA, the restrictions they put on you, and the other regulatory agencies, is there any relief that might be effected? I don't know whether your writeoff of your antipollution equipment would be of help to you or not.

Mr. DREVS. Yes; it would be, especially in the future. As we look to the synthetic gas plants, coal, fuel, and so forth, the environmental problems that will have to be faced will be tremendous and they will be very costly, and certainly the point made by the electric people applies equally to the gas people and should be taken into consideration because we should have at least the same treatment in order for us in some way to finance those facilities that will be required.

Senator FANNIN. It would be especially true of the coal gasification.

Mr. DREVS. And LNG and SNG plants.

Senator FANNIN. Thank you very much.

The CHAIRMAN. I am going to suggest with regard to the electric utilities that we make the employee stock ownership something that is easier for them to comply with and more attractive for them to get into.

I would like to suggest we allow 2 percent rather than the 1 percent that we have now. I would like to provide, if we go beyond what we do for others, that the condition for doing so for those companies be that they would initiate an employee stock ownership plan. If we suggest something like that, would you want it?

Mr. DREVS. We already have such a plan. We are being held up by one of the technicalities you spoke of and once that is solved, ours will become operational. We do have it all set up.

The CHAIRMAN. I don't want to be critical of the Ways and Means Committee. They are good people. They are a little bit unwieldy because they have a lot more members to work with than we do. It seems to me some of the best ones they have had are now serving on our committee like the man on my left, Senator Curtis. I think maybe some of their shortcomings are due to their good staff people retiring and going out into private practice, like Charlie Davis sitting on your right—good men are needed wherever we can find them.

I would hope that with the expertise available to you, including your own tax counsel, you will show us how we can make the employee stock ownership approach as flexible and as reasonable and as usable with as many options to help meet business' needs as possible. For example, I

for one don't care to in any way prejudice management's control over the affairs of their corporation. I just want the employees to have a piece of the action. That was discussed here in the room earlier today.

I personally would not be opposed to employee stock having voting rights until the employee retired. I would certainly want the employees to share an interest with the average stockholder in wanting to see as much of the pie cut in favor of profits for the company as they can for a simple reason.

When they retire or when they are nearing retirement, they are not going to be drawing wages. They are looking forward to the day when they will be drawing perhaps a pension and drawing dividends off their stock as a second source of income. At that point their interest is just exactly the same as any other shareholders, is that right?

Mr. DREVS. That's right, because he is very interested in seeing his company prosper and seeing that it has enough capital, so he has a double interest.

The CHAIRMAN. Prior to that time, for a young worker, when he is sitting down to talk to management about their interests, it is to his advantage to put the whole thing on the wage end of the scale rather than on the profit side of it. But even he can be made to see by those who are part of the labor force in the long run it is going to be to his advantage that the company make good profits, so there is not necessarily a substantial conflict. But certainly when you get to the older and retired employees, that conflict between labor and management tends to dissolve when they have a substantial interest in the company.

Mr. DREVS. We would agree. We have had an employee stock purchase plan for years. We also have a proposed ESOP. Under the proposed ESOP we permit the employees to vote that stock as soon as it is allocated to them. We have no concern with their turning radical. We think they are good, solid people and we want them to participate.

The CHAIRMAN. It is surprising how a fellow changes when he owns a piece of the action. Thank you very much.

[The prepared statement of Mr. Drevs follows:]

STATEMENT OF ROBERT M. DREVS, CHAIRMAN OF THE BOARD, PEOPLES GAS CO., CHICAGO, ILL., ON BEHALF OF AMERICAN GAS ASSOCIATION

OUTLINE

A. Gas industry's role in U.S. energy

1. Natural gas industry must play an important role if United States national energy goals are to be attained during the remainder of this century.

2. To attain this role, enormous amounts of capital must be raised by the industry. Although proven reserves are declining, substantial reserves remain to be found and developed, provided necessary capital can be raised.

B. Capital requirements

1. The natural gas industry capital requirements in the next decade are estimated at $90 to $100 billion.

2. The gas industry does not have the capital-raising ability to accumulate such sums for supply projects without legislative and regulatory assistance.

3. We are advised by investment bankers that we will not be able to raise in the capital markets the required amounts needed because of:

(a) potential political resistance to adequate and timely rate increases; (b) necessity of making enormous investments in new, as yet unproven, technologies; and (c) indecision and uncertainty as to governmental energy policy.

4. Historically, the natural gas industry has raised about 70% of capital from

external sources, but the huge capital requirements of the coming decade will assert upward pressure.

C. Gas must not be penalized in comparison with electricity

1. The administration has urged certain tax relief measures for the electric industry.
2. The gas industry has capital requirements proportionately equal to the electric industry during the next 10 years.
3. Benefit to the electric segment of the utility industry would penalize gas utilities which raise capital from the same class of investors.

D. Recommendations

1. Increasing the investment tax credit to 12% on a permanent basis.
2. Providing a concurrent investment tax credit on construction work in progress.
3. Providing for faster amortization through increased depreciation rates for non-traditional and existing facilities.
4. Permitting immediate amortization of construction work in progress.
5. Providing, with respect to any changes in the tax laws, that the benefits must be retained by the utility and that regulatory agencies may not require that such benefits be passed through to its customers.
6. Encouraging the purchase of common and preferred stocks of energy utility companies by providing for tax deferral on dividends reinvested in the utility paying the dividend.
7. Defining "utility" broadly enough so that tax legislation will encompass all phases of the natural gas industry—production, transmission, distribution and storage, including a holding company.

STATEMENT

Mr. Chairman and Members of the Finance Committee, I am Robert M. Drevs, Chairman of the Board of Peoples Gas Company of Chicago, Illinois, parent corporation of an integrated energy system engaged chiefly in the production, purchase, transmission, sale and distribution of natural gas. I also appear today on behalf of the American Gas Association (A.G.A.). A.G.A. is a national trade association representing some 300 natural gas distribution and transmission companies. A.G.A.'s member companies provide approximately 85% of the nation's natural gas utility sales to an estimated 160 million consumers.

THE GAS INDUSTRY'S ROLE IN U.S. ENERGY

The natural gas industry must play an important role if United States national energy goals are to be attained during the remainder of this century. However, to fulfill that role, the gas industry must raise a great deal of capital. The purpose of my testimony is to provide you with background information on the gas industry, hopefully to assist you in considering and formulating tax legislation which will foster the growth necessary to enable our industry to raise that needed capital.

Since about 1970, the absolute volume of proven gas reserves has been declining, indicating that production is outstripping new reserve additions. Clearly, if the trend continues, the industry cannot meet existing levels of energy demand, much less increases in demand projected to occur in the future.

An even more disturbing fact, however, is that in 1974, despite a 19.2% increase in domestic oil and gas wells drilled, only 8.4 Tcf (trillion cubic feet) of natural gas were added to U.S. reserves, compared to 1974 production of 22 Tcf, a net reduction in reserves of 14 Tcf. When I testified on the subject of tax reform before the Ways and Means Committee of the House of Representatives in July of last year, I referred to forecasts of severe curtailments of gas service expected for the winter just passed. Fortunately, our winter weather was much warmer than normal on a nationwide basis. For example, in Chicago, we are experiencing one of the warmest winters in over 40 years, being 9% warmer than normal. The country thus avoided the spectacle of plant closings and resultant job losses. However, this happy fact did not solve our basic problem: it only gave us a modest breathing spell to work on its solution. I am sorry to say that nothing has happened legislatively since last July to relieve the problems of gas supply.

It is clear to us that the gas industry must play a major role in meeting energy goals. In 1974, gas provided about 30% of the nation's total energy despite sub-

stantial curtailments. Even after reflecting substantial economic growth, natural gas will provide approximately 20% of total energy supply in 1985 according to Department of Commerce projections. This means delivering a volume equal to the 1974 deliveries of 22 Tcf in face of falling reserves. Failure to meet supply goals would, of course, result in increased reliance on energy imports. In 1975, 37% of petroleum consumed was imported at a cost of $27 billion.

Substantial gas reserves do remain to be found and developed. The precise quantities of unfound natural gas can only be determined by drilling. The easily available gas has been found. Not only are new fields harder to find but wells must now be drilled 20,000–30,000 feet deep at costs per well in excess of $5,000,000.

The Energy Research and Development Administration has presented strong arguments for emphasizing the continued development of gas and other traditional domestic energy resources. In Volume I of its *A National Plan for Energy Research, Development and Demonstration*, Which presents priorities for the development of U.S. energy resources, ERDA concludes that for the shortterm (1975–1985), the nation's immediate energy needs must basically be met with existing energy systems. Therefore, ERDA's short-term priority for new supply is further development of these systems, including enhanced gas recovery mechanisms. For the mid-term (1985–2000), ERDA's priorities are the development of synthetic gas from coal and the extraction of oil from shale.

Natural gas presents particularly attractive opportunities for increased production, both from traditional and from synthetic gas sources. Compared with electricity, natural gas requires only ⅕ and synthetic gas ⅖ the dollar investment per Btu of energy produced.

The gas industry's program for meeting the needs of its market is generally consistent with the proposed by ERDA. Incremental supplies for the next five years in our judgment must come from the lower 48 states and the Gulf of Mexico.

Gas from so-called tarditional sources must, of course, be supplemented. Gas industry members are presently involved in the development of at least four large scale coal gasification projects using existing technology and western coal. Our own experience at Peoples Gas System indicates that complexes which are capable of delivering 250 million cubic feet per day of synthetic gas from coal, cost in excess of $1 billion each. One such project has been granted a conditional certificate by the Federal Power Commission and it waits the formulation of a financing plan. The sponsors of that project have indicated that they are unable to finance absent some form of governmental assistance.

The gas industry is also hard at work to make available Alaskan gas to the lower 48 states. There are currently two such projects which are involved in a proceeding before the Federal Power Commission. Whichever of these two projects is approved eventually, the cost will be approximately $10 billion at the time of completion.

The gas industry has already constructed and has in operation plants which produce synthetic gas from liquid petroleum feedstocks. Our system has just put-on-stream such a plant which produces approximately 160 million cubic feet of gas per day and which was constructed at the cost of $100 million.

In addition, industry members have a number of projects in varying stages of development for the importation of liquified natural gas from foreign sources. In common with other supplementary supply projects, these LNG schemes require enormous amounts of capital to finance liquefaction facilities at the foreign source, especially designed cryogenic tankers and the construction of storage and gasification facilities in this country.

CAPITAL REQUIREMENTS

Investments by the natural gas industry for the next decade, when expenditures for supplemental supplies will become a major item, are estimated by several sources at $90 to $100 billion. The capital requirements problem is impacting the industry much more severely since the gas shortage first began to be felt about five years ago.

Previously, interstate pipelines depended upon independent producers almost exclusively to develop new gas supplies. However, with deliverability from, and reserve additions to, traditional supplies falling off, and with continued regulation which requires producers to charge far less than the economic value of

natural gas sold in interstate commerce, pipelines have had to make interest-free advance payments to producers and equity investment in order to get gas. This has, of course, substantially increased the cash requirements of the natural gas industry and at the same time made more difficult the problem of raising the necessary capital. In the future, the industry faces far larger capital commitments for coal gasification, Arctic gas, SNG and LNG projects.

The gas industry, however, just doesn't have the capital-raising ability to finance such supply projects without legislative and regulatory assistance.

For example, over the next 10 years, Peoples projects additional investments of $6.7 billion, if it is to meet the needs of its markets. That compares with present book assets of $2.2 billion. In a single decade, we propose to triple the present investment accumulated over the 120 years of our existence. Other gas companies are in the same situation.

We are advised by our investment bankers that we will not be able, without assistance, to raise in the capital markets the required amount of capital for the projects we believe we should undertake. That is an unfortunate fact in a capitalistic economy. It is attributable to a combination of factors, including:

Political resistance to adequate and timely rate increases in the prices we can charge our customers and the prices our suppliers charge us. Customers should ultimately pay the costs of what they want, but investors are not convinced they will be permitted to do so.

The necessity to make enormous investments in new technologies where the economics are as yet unproven. This is further compounded by the existence of very long lead times, before millions of dollars of investment became productive.

The indecision and uncertainty as to government energy policy, which increases investor uncertainty.

These are the facts that face top management in the gas industry. Regardless of economists' theories, if we cannot find the financing for these projects, the investments cannot be made.

Historically, the natural gas industry has had to raise about 70% of its capital from external sources. Huge industry capital requirements of the future will exert further upward pressure on this percentage. Therefore, capital formation is going to be a major concern of the industry for years to come. We strongly urge that the industry needs economic incentives, including revisions of the tax laws, which will permit adequate cash generation.

GAS MUST NOT BE PENALIZED IN COMPARISON WITH ELECTRICITY

We are well aware of the administration's proposals, based on recommendations of the President's Labor Management Committee, to benefit the electric industry with certain tax relief measures. These were presented to this Committee by Secretary Simon in his March 17 testimony. To my knowledge, the comparable problems of the gas industry were not considered by that Committee.

I would point out to you that if you benefit just one segment of the utility industry, you will make it more difficult for the remainder of the industry to raise the required capital from the same class of investors. Thus you rob Peter to pay Paul.

The gas industry has capital requirements proportionately equal to the electric industry during the next ten years. In addition, *gas company common stocks are presently selling at lower price earnings ratios* than electrics and, in most cases, below book value, and gas company senior securities have very large sinking fund requirements which must be met in the next decade in addition to the huge new capital requirements. The capital problems of the gas industry are every bit as great as those of the electric industry and would be worsened if gas companies should not be eligible for any assistance extended to the electric industry.

RECOMMENDATIONS

As to specific suggestions for consideration by the Senate Finance Committee, the generation of internal and external capital could be substantially improved by:

(1) Increasing the investment tax credit to 12% on a permanent basis;

(2) Providing a concurrent investment tax credit on construction work in progress;

(3) Providing for faster amortization through increased depreciation rates for non-traditional and existing facilities;

(4) Permitting immediate amortization of construction work in progress;

(5) Providing, with respect to any changes in the tax laws, that the benefits must be retained by the utility and that regulatory agencies may not require that such benefits be passed through to its customers;

(6) Encouraging the purchase of common and preferred stocks of energy utility companies by providing for tax deferral on dividends reinvested in the utility paying the dividend; and

(7) Defining "utility" broadly enough so that tax legislation will encompass all phases of the natural gas industry—production, transmission, distribution and storage, including a holding company.

In addition to tax reform, further measures by Congress as well as Federal and State regulatory agencies will be necessary. In the producing segment of the gas industry, deregulation of the wellhead price of gas would give powerful impetus to raising new capital as will continued deductions for tax purposes of intangible drilling costs and of geological and geophysical costs. More consistent administrative and legislative leadership is necessary to improve the earnings of regulated companies, and to reduce regulatory lag both as to rates and as to the approval of new projects.

In summary, it is urgent that the United States develop priorities to meet the overall energy goals of increasing domestic energy production and providing capital for an energy program. The gas industry plays, and must continue to play, a major energy role. The specific recommendations I have made here will help the entire economy, and in particular capital-intensive industries.

The CHAIRMAN. Our final witness this morning is Mr. Donald M. Gamet, vice chairman for tax practice of Arthur Andersen & Co., accompanied by Mr. William C. Penick, tax partner.

I am hopeful you gentlemen may be able to offer us a few suggestions by way of simplification on tax reform. We welcome your testimony, Mr. Gamet.

STATEMENT OF DONALD M. GAMET, VICE CHAIRMAN FOR TAX PRACTICES, ARTHUR ANDERSEN & CO., ACCOMPANIED BY WILLIAM C. PENICK, TAX PARTNER

Mr. GAMET. Thank you, Mr. Chairman.

We hope so, too. Unfortunately, all of our detail is not yet ready, but we will submit it in the very near future and get it to you.[1]

My name is Donald Gamet. I am the vice chairman in charge of tax practice for Arthur Andersen & Co. With me is Mr. William Penick, who is a partner in our tax division. We are an international accounting firm with over 100 offices in approximately 35 countries. Our practice entails many different kinds of businesses and we have had a wide range of experience in the methods and economics of business as well as the impact of taxation.

In the brief time allotted this morning, I would like to touch on three areas of concern to us. The first of these deals with capital formation.

Over the last few years we have become increasingly concerned over the failure of the tax system as written to adequately recognize the impact of inflation and the bias in that system against savings and capital formation. This is especially important when we view it in light of the actions taken by other major industrial countries dealing with these same problems and who compete with U.S. business in the world markets.

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[1] See p. 1533.

After considering a great many alternative approaches, we have developed a series of tax concepts which we think if they are implemented over a reasonable period of time, and it would take some time because it would have an impact on the revenues, that they would remove a substantial amount of the present bias against capital and encourage the formation of more capital to meet the needs of our country and industry.

As I said, this study is not yet in final form, but we will have it within 10 days and submit it to your committee. We will appreciate having that study included in the record of these hearings.[1]

The following are the major elements that we will suggest in that study:

1. A deduction from income for capital erosion resulting from inflation or, as it is sometimes known a capital maintenance deduction.

2. A partial integration of corporate and shareholder taxes through a dividends-paid deduction. That is not the only way to do it, but we think it is the most feasible way.

3. Added incentives for personal savings, including expansion of employee stock ownership. We share in Mr. Kelso's concern over the need to expand the capital ownership in this country. We think the two great challenges facing American industry are to get formation of more capital; and second, get it spread so that the class conflict—that seems to be developing over it can be alleviated, at least to some extent.

4. We would also suggest the deferral of capital gains taxes until the funds are withdrawn from the pool of capital. It does not make sense to us to tax rollovers of capital when the only effect is to reduce the capital we already have. It seems to us, if you do that, it then would be entirely feasible to tax the real capital gains at ordinary rates when they are finally withdrawn and consumed.

We believe if these concepts were implemented over a period of time they would then permit a great deal of simplification of the highly complex system we have because it would do away with the need for some of the complex provisions that we now have to deal with abuses.

The second point that we are concerned with is the taxation of foreign income. This arises out of our international practice. We have clients in most of the major industrial nations of the world, outside of the Iron Curtain. We have an opportunity to observe those clients in all parts of the world and to see how the economics of international business affects them in multinational trade and particularly how the different tax systems with which they must cope have a bearing upon their ability to compete with companies from other countries.

We are greatly concerned about the proposals for substantial change in the U.S. taxation of foreign-source income, particularly the elimination or reduction of deferral of taxation on unremitted foreign earnings. We think if put into effect that will not result in any significant increase in tax but it will result in a significant diminution of the competitive position of U.S. industry in foreign markets.

That study, too, is nearing completion and will be submitted at the same time as the capital formation study.[2]

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[1] See p. 1542.
[2] See p. 1567.

The third point relates to the introduction into the tax system of unnecessary complications relating to the use of tax incentives. A major piece of the tax legislation being considered by your committee this year is the Tax Reform Act of 1975, H.R. 10612, passed by the House of Representatives last December.

In reviewing that House bill we were very much distressed by the extreme complexities of some of the changes that were proposed. In particular, the limitations on accounting losses, the LAL concept, would add great complexity to and further confuse an already extremely confusing area of taxation. We very seriously question whether the results achieved by those provisions would in any way justify the many problems they could raise.

In addition, the LAL approach is so unduly harsh in its impact on certain industries that it would severely disrupt the flow of capital to them.

The CHAIRMAN. Don't these complexities in the tax laws make money for Arthur Andersen?

Mr. GAMET. They do, but we don't need to make money that way, and I have no doubt about our ability to make money after those are removed.

Several alternatives to the LAL approach and to the present tax preference system have been proposed. We have given thought to all of these. In particular the minimum taxable income approach seems to us to have the most merit assuming we have to attack the problem at all.

In analyzing these proposals certain basic points must be kept in mind and that we have proceeded on. First, we support the idea that incentives in our tax system to achieve certain economic and social objectives are proper. Furthermore, we think it appropriate that Congress periodically review these incentives to see if they are still needed and see if they are still fulfilling their objectives.

Second, we think it is desirable within this framework to permit the individual investor as much flexibility as we can to choose the projects he invests in. We believe in the long run that is not only sound tax policy but it will channel investment funds toward those activities that provide rewards commensurate with the risks and with the relative needs of the various industries that are competing for those funds. We recognize there may be some particular activities that are necessary in the public interest and that are not able to attract capital on the basis of the return they offer on investment. Congress will have to consider the adoption of incentives to take care of those specific things. I don't think it is necessary to muddy up the waters for everyone to take care of those few.

As indicated earlier, we are concerned with the complexity of the tax law as it now stands and the addition of complicated tax laws such as LAL only compounds them. If Congress decides that benefits from tax incentive programs need to be eliminated, we think a more direct approach would be to establish a minimum level of income on which all taxpayers would pay tax and restrict in some way the incentive benefits to achieve that level.

By adopting the minimum taxable income approach, where all incentives are combined for purposes of establishing that level of income,

we would retain the progressivity of our tax structure and we could also preserve the system without these unnecessary complications that are being built into it.

We have analyzed a number of the alternatives proposed for this purpose and the one that seems to best meet the reasonable standards of simplicity while still achieving the basic goals of limiting overall tax incentive investment could be along those lines:

Congress would consider preferences and the minimum level of income on which an individual ought to pay tax.

An individual would then be required to pay the higher of his regular income tax on taxable income after tax preferences, or the tax at regular rates on a portion of his expanded taxable income after adding back the preference items in total.

To the extent that those preference items were not used in 1 year, they should be carried forward.

We have put together some comparisons based on actual cases taken from our files and we have compared the results under the Tax Reform Act passed by the House, considering LAL, under present law, and under the alternative approach. These are actual cases. We have modified them only as necessary for clarity and simplicity. We have assumed the minimum income level would be at 50 percent. We have two examples for real estate and one for oil and gas.

The first example involves a corporate executive with earned income and investment income. He has put $2.2 million into a rental housing project qualifying under section 236. The main objective is accelerated depreciation at 200 percent.

Under LAL all of that accelerated depreciation would be deferred. In the third year this same investor put $2.8 million into a shopping center project. Here his depreciation was 150 percent declining balance and he, of course, got deductions for construction period interest and taxes. LAL would also push those forward.

You can compare his taxes under these alternatives by the summary on page 8, but the substance of that data is that the average increase in taxes in the first 2 years under the House bill is nearly $208,000 on a $2.2 million investment. That is a decrease in yield of nearly 10 percent. In our experience an investor in a 236 housing project would expect to recover his money in 5 to 8 years. If you apply LAL to him, his payout period will be extended to such an extent that we don't believe he is going to put money in that kind of project.

In the third and fourth years his taxes would be increased by LAL by $354,000 and $258,000, respectively. Under the impact of these increases the effect on his yield from a total investment of $5 million would be so great that again in all likelihood we believe he would not make the investments.

An investor in a commercial real estate venture like this, in our experience, would expect a return on his investment of 16 to 20 percent in total, of which 8 to 10 percentage points, roughly one-half, would be attributable to economic factors other than tax benefits.

It seems to us unless Congress specifically wants to discourage the construction of these things that the passage of a LAL would be inconsistent to say the least.

In the interest of time I will jump over example B and go down to the oil and gas venture and then you can cover the other example at your leisure or in questions if you like.

Example C involves a taxpayer with $200,000 of recurring taxable income primarily from interest and dividends. He took a 50-percent interest in drilling two development wells, each of which has a completed cost of $205,000. One is a fairly typical producer, that is for a development well, and the other is a very good producer. Less than 1 out of 20 development wells would fall in that latter category.

The other basic assumptions are set out in the example itself.

The comparison that we show is between present law and the LAL; the minimum taxable income approach would produce the same results as present law so we have not shown it separately. The example assumes he holds the properties for 5 years and then sells them. The table on page 10 shows the income taxes but the real issue is what is left after taxes and that is presented on the next page.

You can see from that the discounted cash flow from the investor's other economic activities for the next 5 years if he did not go into any oil ventures would be $378,000. Under an LAL concept, all he would get by investing over $200,000 in risky development drilling is $66,000. That is the difference between the $444,000 under the House bill and the $378,000 he would have if he stayed out of oil operations altogether.

Now, he could take that same $200,000 and invest it in a 5 percent municipal bond and get $40,000 additional income, and it wouldn't make any sense to him to go drill an oil well for the $26,000 difference between those two alternatives open to him.

It seems clear to us if the LAL provisions are passed they would effectively shut off whatever remains of the flow of money from outside investors such as this one into developmental drilling.

These are only three examples of this impact. We could develop more if they would be useful to you and we would be pleased to do so.

We indicated earlier we are greatly concerned over the complexities created by the House bill. We have put together a little piece of information you don't have which Mr. Petnick will give to you now.

The CHAIRMAN. We have a copy here.

Mr. GAMET. It seems to us the simplicity of what we are proposing here can best be demonstrated by the tax return forms needed to implement these provisions. The one on the lefthand side is minimum the actual tax form now in use under the present law. As you can observe, it requires a full page of computations just for the minimum tax. We thought about trying to develop one for the LAL but we did not think we were up to the task. I can assure you it will be more than twice as big as what we already have there.

By contrast, look at the right side. The proposed minimum taxable income would be about half a page of computations and that could be understood by any taxpayer who is likely to be involved in such a venture.

The CHAIRMAN. I will ask the two forms be placed in the record at this point.

[The forms referred to follow:]

Form 4625
Department of the Treasury
Internal Revenue Service

Computation of Minimum Tax

▶ Attach to Form 1040

1975

Name(s) as shown on Form 1040 | Your social security number

1 Tax Preference Items. File this form if the total tax preference items (line 2) is more than $30,000 ($15,000 if married filing separately) even though you owe no minimum tax. If this is a short period return, see instructions for line 3. Caution: See "Limitations on amounts treated as tax preference items in certain cases" in instructions.

(a) Accelerated depreciation on real property:
- (1) Low-income rental housing under sec. 167(k) . . . .
- (2) Other real property . . . .

(b) Accelerated depreciation on personal property subject to a net lease . . . .

(c) Amortization of certified pollution control facilities . . . .

(d) Amortization of railroad rolling stock . . . .

(e) Amortization of on-the-job training facilities . . . .

(f) Amortization of child care facilities . . . .

(g) Stock options . . . .

(h) Reserves for losses on bad debts of financial institutions . . . .

(i) Depletion . . . .

(j) Capital gains . . . .

2 Total tax preference items (add lines 1(a) through 1(j)) . . . .
3 Exclusion. Enter $30,000. If married filing separately, enter $15,000 . . . .
4 Subtract line 3 from line 2 . . . .
5 Amount from Form 1040, line 18 * . . . .
6 Amount from Form 1040, line 55 . . . .
7 Amount from Form 1040, line 56 . . . .
8 Amount from Form 1040, line 58 for Individual Retirement Bonds . .
9 Tax imposed under sec. 72(m)(5) (premature distributions from self-employed retirement plans) . . . .
10 Tax carryover from prior year(s) (attach statement showing computation) . .
11 Add lines 5 through 10 . . . .
12 Subtract line 11 from line 4 . . . .
13 Multiply amount on line 12 by .10 and enter result . . . .
14 Enter amount of any 1975 net operating loss carryover to 1976 (attach statement showing computation) . . . .
15 Multiply amount on line 14 by .10 and enter result . . . .
16 Deferred minimum tax—enter amount from line 13 or line 15, whichever is smaller . . . . . .
17 Minimum Tax. Subtract line 16 from line 13 . . . .
18 Enter minimum tax deferred from prior year(s) until this year (attach statement showing computation)
19 Total minimum tax. Add lines 17 and 18 . . . .
20 Excess credits. See instructions for line 20 before completing this section. If Form 1040, line 18 is more than zero, omit lines 20(a) through (e) and enter the amount from line 19 on line 21.
- (a) Credit for personal exemptions . . . .
- (b) Retirement income credit . . . .
- (c) Credit for political contributions . . . .
- (d) Credit for purchase of new principal residence . . . . . .
- (e) Add amounts on lines 20(a) through (d) . . . .

21 Subtract line 20(e) from line 19. Enter here and on Form 1040, line 57 . . . .

* Do not include any tax imposed under sec. 402(e) (ordinary income portion of lump sum distributions) or any partial tax under sec. 668 (accumulation distributions by trusts), see special rule—proposed I.T. Regs. sec. 1.56–1(c).

16—83644-1

PRO FORMA FORM

Form 4625
Department of the Treasury
Internal Revenue Service

~~Computation of~~ Minimum Tax ABLE INCOME

▷ Attach to Form 1040

1975

Name(s) as shown on Form 1040 | Your social security number

1 Tax Preference Items. File this form if the total tax preference items (line 2) is more than $30,000 ($15,000 if married filing separately) even though you owe no minimum tax. If this is a short period return, see instructions for line 3. Caution: See "Limitations on amounts treated as tax preference items in certain cases" in instructions.

(a) Accelerated depreciation on real property:

(1) Low-income rental housing under sec. 167(k) . . . .

(2) Other real property . . . .

(b) Accelerated depreciation on personal property subject to a net lease . . . .

(c) Amortization of certified pollution control facilities . . . .

(d) Amortization of railroad rolling stock . . . .

(e) Amortization of on-the-job training facilities . . . .

(f) Amortization of child care facilities . . . .

(g) Stock options . . . .

(h) Reserves for losses on bad debts of financial institutions . . . .

(i) Depletion . . . .

(j) Capital gains . . . .

2 Total tax preference items (add lines 1(a) through 1(j)) . . . .

3 Amount from Form 1040, line 47

4 Add line 3 to line 2

5 Divide amount on line 4 by 2

6 If amount on line 5 is greater than amount on

7 line 3, figure tax thereon using appropriate

8 rate schedules, and enter result on line 16a

9 of Form 1040.

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*Do not include any tax imposed under sec. 402(e) (relating to the ordinary income portion of lump sum distributions) or any partial tax under sec. 668 (accumulation distribution by trusts), see special rule—proposed I.T. Regs. sec. 1.56-1(c).

Mr. GAMET. We appreciate very much the opportunity to appear before you this morning and we will be pleased to answer any questions you might have.

The CHAIRMAN. Let me say when you come in here representing Arthur Andersen & Co., complaining about the complexity of the tax law, that reminds me of the story Bob Kerr used to love to tell on this committee about the manager of the ball team who had a young player out in center field, the man made a couple of errors and the manager said, "You just sit here on this bench and watch me. I will show you how you are supposed to play center field."

The manager goes out there and the first long ball hits him on the head. As they hauled the manager off on a stretcher, the first man who came to see him was the rookie returning to center. He asked the manager, "What went wrong?" He answered, "Son, you have loused up center field so bad that by now nobody can play it."

Mr. GAMET. I think perhaps the tax law is loused up ——

The CHAIRMAN. I think it had been loused up before, and perhaps we ought to be moving in the other direction.

Senator Curtis.

Senator CURTIS. I very much appreciate your discussion. I have a strong feeling that many crimes are committed in the name of tax reform. Aside from the humor of it, it is very damaging to our economy.

In reference to your minimum taxable income proposal, does your proposal in general parallel what the Treasury has proposed?

Mr. GAMET. Yes.

Senator CURTIS. I think the first objective of taxation should be justice rather than the amount of revenue that the Treasury receives. However, just as a matter of information, could a simplified proposal along the lines of the Treasury Department recommendation, and what you have discussed here, could be structured to reach the same level of Federal revenue as a more complicated system just merely by dealing with the percentages and possible rates?

Mr. GAMET. That is true. You can do anything you want with it but without significantly increasing its complexity.

Senator CURTIS. Do I understand that, under this minimum taxable income proposal, a critical issue is the determination of what portion of this income should be included and then applying the regular rates?

Mr. GAMET. That is correct.

Senator CURTIS. I appreciate your testimony very much. I think it has been most helpful.

Senator FANNIN. Certainly your statement will be very helpful to us, Mr. Gamet. You have gone into some of the LAL proposals extensively and we will have to absorb that information. I know the realtors were here a few days ago and they had a simplified proposal where you take the taxable income, add on the tax preferences, divide by two and that would either be the amount or if the regular taxable income were greater, that would be that amount.

Mr. GAMET. It is similar to that.

Senator FANNIN. I understand there are complications in other industries where this might not work out so well. Is that true?

Mr. GAMET. I am not aware of anywhere it would not work out.

Senator FANNIN. For instance, in the oil industry?

Mr. GAMET. It will not have the same big difference in effect that it would have on real estate.

Senator FANNIN. One item is very much misunderstood and is of great concern to many people. That is that everyone should pay a share of taxes. That is why the minimum income tax provision was not adopted on the basis of equity but on the basis of philosophy.

As far as the minimum income provision, how successful has that been in providing equity?

Mr. GAMET. I don't know that I could answer that. I would have to have a great deal more information about the total tax population to answer that. I judge that both the Treasury and your own staff feel probably it has not been successful. We do not have the information that would be necessary to address that question.

Senator FANNIN. From the standpoint of capital formation, from the standpoint of providing investments, and all, has this been a deterrent?

Mr. GAMET. It is certainly a deterrent to getting capital into those industries. Whether it is a deterrent in the total formation of capital again would require some pretty sophisticated studies. I am not really able to answer whether they reduce the total capital available or merely change the places where the total goes.

Senator FANNIN. You know, we do have complaints. In trying to have the tax laws become equitable you sometimes step on one foot when you are trying to help the other.

Mr. GAMET. It would reduce capital dollar-for-dollar by the increase in taxes but I think the capital formation problem we are concerned about will not be solved with a dollar-for-dollar trade. We need substantial leverage.

Senator FANNIN. We need the incentives and I know you covered that in your statement. I was just trying to bring out some of the misconceptions that exist today in people thinking they have accomplished a great deal to overcome most problems just by having the minimum income tax.

Mr. GAMET. I think we have seen that shuffling tax provisions only results in denying capital to some industries without materially contributing to the solution of the underlying problems.

Senator CURTIS. I think you have focused on a good point when you referred to the preference items as "incentives." Each one of those incentives was placed in the Internal Revenue Code for a very valid purpose and in the interest of you economy.

The demand for a minimum income tax arises out of the ability of some people to use all of those incentives or a combination of them so that they do not contribute a fair share to the cost of Government. Is that our problem?

Mr. GAMET. That is right.

Senator CURTIS. On the other hand, if the minimum income tax is such a burden that it destroys these incentives, then we are in almost the same position as if the incentives themselves were repealed. Yet, each one of these incentives is in the Internal Revenue Code for a good and valid reason. Is that correct?

Mr. GAMET. That is correct. That is why we feel an approach should be taken that would be successful in curbing the worst of the abuses but not just shut them out like the LAL would do.

Senator CURTIS. At the present time, is tax-exempt interest included in the minimum tax?

Mr. GAMET. No.

Senator CURTIS. Thank you very much.

[The prepared statement of Mr. Gamet and two studies referred to follow:]

STATEMENT OF ARTHUR ANDERSEN & CO., SUBMITTED BY DONALD M. GAMET

My name is Donald M. Gamet and I am the vice chairman in charge of tax practice for Arthur Andersen and Co. Arthur Andersen is an international accounting firm with over 100 offices in approximately 35 countries. Our practice entails many different kinds of businesses and we have had a wide range of experience in the methods and economics of business as well as the impact of taxation.

In the brief time allotted this morning, I would like to touch on three areas that are of great concern to us.

INFLATION, TAXATION AND CAPITAL FORMATION

Over the last few years we have become increasingly alarmed over the failure of our tax system to recognize the impact of inflation and the bias in that system against savings and capital formation. This becomes more important when viewed in the light of actions taken by other major industrial countries in dealing with the same problems, who compete with us in world markets.

After a great deal of consideration of alternative approaches, we have developed a series of tax concepts which if implemented over a reasonable period of time would remove some of the present bias against capital and encourage the development of more capital to meet the many needs of our country. This study has not been completed in final form but it shou'd be available within the next few weeks and copies will be submitted to your committee for the record of these hearings.

Following are the major elements of our program: (1) Deduction for capital erosion; (2) partial integration of corporate and shareholder taxes through a dividends paid deduction; (3) added incentives for personal savings, including expansion of employee stock ownership; (4) deferral of capital gains taxes until funds withdrawn from pool of capital; and (5) taxation of real gains at ordinary rates.

Finally, the concepts we recommend would when implemented permit considerable simplification of our highly complex tax system.

TAXATION OF FOREIGN INCOME

Our practice is international in scope and, in serving many clients in all parts of the world, we have had a chance to observe the economics of international business. In particular, we have observed the impact of taxes, both foreign and domestic, on international business activities. We are greatly concerned about some of the proposals for substantial changes in the U.S. taxation of foreign source income, particularly the elimination or reduction of deferral of taxation on unremitted foreign earnings, and further restrictions on the foreign tax credit. We are nearing completion of a comprehensive statement of our views on this subject, and it too will be submitted to your Committee for inclusion in the record.

SIMPLIFICATION OF TAX LAW

The major piece of tax legislation being considered by your Committee this year is the Tax Reform Act of 1975 (H.R. 10612), passed by the House of Representatives last December. In reviewing the House bill, we were immediately struck with the incredib'e complexities created by some of the changes that were adopted. In particular, the proposals that would restrict or remove some of the tax incentive provisions in present law such as the Limitation on Accounting

Loss (LAL) concept would add great complexity to an already confusing area. We seriously question whether the results achieved justify the increased complexity that would be created.

In addition, the LAL approach is so unduly harsh that its impact on certain industries may be to sharply curtail the flow of capital into them, rather than correct abuses.

Several alternatives to the LAL approach and to the present tax preference system have been proposed, and we have given considerable thought to them. In particular, the minimum taxable income approach that has been suggested has merit.

In analyzing these proposals, there are several basic points that should be kept in mind.

1. First, we support the premise that incentives in our tax system to achieve certain economic and social objectives are proper. Furthermore, we think it appropriate that Congress periodically review these incentives to see whether or not they should be continued and whether or not they are accomplishing their objectives.

2. Second, we think it desirable to permit the individual investor as much flexibility as possible to choose the projects in which he wishes to invest. We believe that, in the long run, this is sound from an economics viewpoint in that investment funds will be channeled toward those activities that provide rewards commensurate with risks. To the extent that particular activities, necessary in the public interest, are not able to attract capital, Congress should consider the adoption of incentives that would assist in obtaining the capital needed.

3. As indicated earlier, we are concerned with the complexity of the tax law as it now stands, and the addition of complicated concepts like the LAL and tax preference systems only compounds the problems. Accordingly, if Congress decides for policy reasons that benefits from tax incentive programs should be limited, and there is an easier way of accomplishing that objective, we think it should be considered. A more direct approach would be to establish a minimum level of income on which all taxpayers should pay tax, and then restrict in some fashion the incentive benefits to achieve that minimum level.

4. By adopting the minimum taxable income approach, where all incentives are combined for purposes of establishing that level of income, the progressivity in our tax structure could be preserved and the operation of the system would be much simpler.

5. We have analyzed several of the proposals that have been made and the one that seems to meet reasonable standards of simplification while still achieving the basic goal of limiting overall tax incentive investment would be along the following lines:

A. Congress should decide: (1) What types of incentives should be considered preferences; and (2) What percentage of income should be the minimum on which an individual should pay tax?

B. An individual will be required to pay the higher of: (1) Regular income tax on taxable income after considering preference items; or (2) Tax at regular rates on a portion of expanded taxable income, adding back preference items in total.

C. To the extent that preference items for a given year exceed those allowable under B(2) above, the excess should be carried over to subsequent years.

The appropriate factor to apply to expanded taxable income is in itself a policy decision that should be made by Congress. If the incentive provisions in the tax law that create the types of preferences which should be limited are needed to achieve important economic and social goals, we would generally support a low percentage in determining the appropriate minimum taxable income level.

Comparison of results under different approaches

On the assumption that Congress decides that 50% of "expanded taxable income" is appropriate, we have worked out comparisons of the results (1) under present law, (2) under the Tax Reform Act as passed by the House (considering LAL and other relevant changes), and (3) under this alternative approach. These examples are based on typical taxpayer situations with a minimum amount of modification for the sake of clarity and simplicity. Two examples are presented for real estate investments and one for oil and gas drilling and exploration.

Real estate investments

Example A—Individual Investor in Rental Housing and Commercial Property

Our first example involves a corporate executive who has both earned income and investment income (dividends and interest). After careful consideration, he invested $2.2 million in a rental housing project, qualifying under Section 236 of the Housing Act. The main tax incentive from this type of investment is the use of accelerated depreciation which is permitted at the 200% declining balance rate. Under LAL the excess of accelerated depreciation over straight-line would be for all practical purposes deferred.

In the third year of our example, the investor decides to invest an additional $2.8 million in a commercial real estate project. Here, his depreciation is limited to the 150% declining balance method, but, under LAL, he would not only be denied the current deduction of up to one-third of that depreciation, but also a substantial amount of construction period interest and taxes.

Example A compares our investor's tax position under present law, under the House bill, and under the alternative minimum taxable income approach. Following is a summary of the amounts of Federal taxes due:

Year	Present law	House bill	Minimum taxable income
1	$52,400	$286,000	$128,500
2	34,000	216,000	93,800
3	26,100	380,500	175,700
4	80,200	338,500	154,700

The average increase in taxes for the first two years under the House bill is nearly $208,000. On a $2.2 million investment, this is a decrease in yield of nearly 10%. In our experience, an investor in a Section 236 housing project would hope to recover his investment in 5 to 8 years. The results under LAL would extend payout to such an extent that the investor would be most unlikely to invest.

For the third and fourth years, our investor's taxes would increase by roughly $354,000 and $258,000, respectively. Again, the impact of these increases on his yield from a total investment of $5 million would be so great that in all likelihood he could not make the investments. Since an investor in a commercial real estate venture would normally want at least an 8% yield plus tax benefits, the substantial decrease in such benefits caused by the LAL system would make many ventures unacceptable to an investor.

If we can assume that Congress wishes to encourage the construction of rental housing and commercial building through permitting accelerated depreciation, the enactment of the LAL concept, which would thwart the realization of that objective, seems inconsistent to say the least.

Example B—Section 236 Housing Project

Example B compares the results for a "high quality" Section 236 project under present law and under LAL. The rates of return are reflected on the top schedule, assuming 50%, 60%, and 70% tax brackets. No comparison is made with the alternative minimum taxable income proposal, since the results would depend on each individual taxpayer's tax position. The key point that should be emphasized is the very substantial decrease at all levels caused by the LAL proposals.

For example, using the "10 times cash flow" assumption as the ultimate sale price, the rate of return to a 50% tax bracket investor drops from 7.8% under present law to less than 1% under LAL. It is not likely that the investor would invest were LAL enacted.

Oil and gas drilling venture

Our Example C involves a taxpayer with $200,000 of recurring taxable income, primarily from interest and dividends. He takes a 50% interest in drilling two "development" wells, each of which has a completed cost of $205,000. One is a fairly typical producer (for a development type well) and the other is a very

good producer. Less than 1 out of 20 development wells would normally fall in the latter category. The other basic assumptions are set forth in the example.

While the comparison shown is between present law and LAL, the minimum taxable income approach would in this situation produce the same results as present law. Accordingly, this is not shown separately.

Our example assumes that the investor holds the properties for 5 years, and then sells them. Following are summaries of some of the pertinent results:

Total taxes payable:

Year	Present law and minimum tax income	House bill
1	$55,000	$114,000
2	127,000	111,000
3	124,000	111,000
4	122,000	111,000
5	145,000	169,000
Total	573,000	616,000

Following is an analysis of the taxpayer's cash flow (both actual and discounted) under the House bill and present law, together with a comparison to his cash flow if he had not participated in the drilling. Amounts are shown in thousands of dollars, and a 9% discount rate is assumed.

Year	Present law		House bill		No drilling	
	Actual amount	Discounted value	Actual amount	Discounted value	Actual amount	Discounted value
1	($11)	($11)	($69)	($69)	$89	$89
2	117	107	132	121	89	82
3	114	96	127	107	89	75
4	112	86	124	96	89	69
5	290	205	267	189	89	63
Total	622	483	581	444	445	378

On a very speculative investment of over $200,000, the investor under present law would have an after tax profit of about $105,000 ($483,000 minus $378,000) over a 5 year period. Under the House bill, that profit drops to $66,000 ($444,000 minus $378,000). This shortens the investment odds significantly and the investor would be much less likely to risk his funds.

We must also keep in mind the likelihood of a dry hole, even though the drilling prospects are classified as development well. If the wells are dry, the taxpayer in this example would be out of pocket over $35,000, after considering the deductibility of dry hole costs.

The important point again is that, by cutting back on the tax incentives, the LAL approach is likely to discourage a taxpayer from making an investment that Congress has thus far sought to encourage.

These are only three examples of the impact of LAL, and the first one shows the relative simplicity of the minimum taxable income alternative. Examples involving other types of tax incentive programs can be developed if that would assist your Committee in its consideration of these proposals. We would be pleased to provide these if you so desire.

* * * * * * *

As noted earlier, we are greatly concerned with the complexities that would be created under the House bill. The average taxpayer is confused enough as it is by present law. If complexities continue to be adedd to the system, we believe that the lack of understanding and confidence by many taxpayers will reach such a point that our entire self assessment system may be in jeopardy. Accordingly, we favor a simpler approach to the limitation on tax benefits from incentives if your committee believes that a limitation is appropriate.

We appreciate the chance to appear before your Committee and will be pleased to try to answer any questions you might have.

REAL ESTATE INVESTMENT, RESIDENTIAL HOUSING AND SHOPPING CENTER DEVELOPMENT (JOINT RETURN)

	Year 1	Year 2	Year 3	Year 4
A. Taxable income under present law	$50,000	$20,000	$10,000	$100,000
Tax thereon:				
Regular tax	17,100	4,400	1,800	45,200
Preference tax	35,300	29,600	24,300	35,000
Total	52,400	34,000	26,100	80,200
B. Under House Bill (H.R. 10612):				
Taxable income as above	50,000	20,000	10,000	100,000
Add deductions not allowed under LAL:				
Excess depreciation	400,000	330,000	275,000	425,000
Construction period interest and taxes			300,000	
Total unallowable deductions	400,000	330,000	575,000	425,000
Taxable income under House Bill	450,000	350,000	585,000	525,000
Tax thereon	286,000	216,000	380,500	338,500
C. Under alternative (M.T.I.) proposal:				
Taxable under normal rules	50,000	20,000	10,000	100,000
Add preference items	400,000	330,000	575,000	425,000
Expanded taxable income	450,000	350,000	585,000	525,000
½ thereof	225,000	175,000	292,500	262,500
Tax thereon	128,500	93,800	175,700	154,700

Note: 1. Deductions deferred under LAL total $1,730,000 through year 4. 2. Preference carried forward under alternative proposal total $775,000 through year 4.

EXAMPLE B

SEC. 236. HOUSING PROJECT, RATES OF RETURN ON INVESTMENT

	50 percent tax bracket	60 percent tax bracket	70 percent tax bracket
ASSUMING SALE AT $1 OVER MORTGAGE BALANCE			
Cash generated at time of sale—$1:			
Rate of return under present law	5.6	11.1	15.4
Rate of return under proposed law	2.1	4.2	8.3
ASSUMING SALE AT 10 TIMES CASH FLOW			
Cash generated at time of sale—$122,000:			
Rate of return under present law	7.3	12.2	16.2
Rate of return under proposed law	.6	5.8	9.4
ASSUMING SALE AT ORIGINAL PURCHASE PRICE			
Cash generated at time of sale—$556,000:			
Rate of return under present law	11.8	15.5	18.9
Rate of return under proposed law	6.8	10.1	12.8

ASSUMPTIONS AND EXPLANATIONS

The purpose of this study is to document the effect on investors of proposed legislation related to LAL (Limitation on Artificial Losses) and the Real Estate Industry. In order to make this study as meaningful as possible, an actual real estate project has been used. The project qualified under Section 236 of the National Housing Act.

The following assumptions and explanations are needed to fully understand this study:

(1) Taxable losses, distributions to partners, and contributions by partners shown for 1970 (year the project began) through 1975 are actual amounts as reported on each year's Federal income tax form 1065. For the years 1976–1981, the amounts are projections based upon actual experience and reasonable expectations of the future.

(2) The interest expense and property taxes paid during construction are actual amounts. Construction was completed in late 1971. The amounts shown

EFFECT OF LAL PROPOSALS ON A SECTION 236 PROJECT

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	Total
Taxable income (loss) reported or projected	($189,733)	($273,863)	($234,895)	($161,646)	($147,677)	($158,990)	($105,022)	($91,196)	($81,370)	($58,945)	($50,382)	($42,432)	($1,596,151)
Deductions disallowed by LAL proposals:													
Interest deduction taken during construction	97,780	137,008											234,788
Property taxes deducted during construction	333	1,897											2,230
Accelerated depreciation in excess of straight line		57,373	133,146	68,582	56,609	43,044	49,377	38,892	30,204	22,036	18,860	15,827	533,950
Taxable income (loss) as revised for effect of LAL	(91,620)	(77,585)	(101,749)	(93,064)	(91,068)	(115,946)	(55,645)	(52,304)	(51,166)	(36,909)	(31,522)	(26,605)	(825,183)

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	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Effect of LAL on taxpayer in the 50-percent tax bracket:												
Income tax savings under present law	$94,867	$136,932	$117,448	$80,823	$73,839	$79,495	$52,511	$45,598	$40,685	$29,473	$25,191	$21,216
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(207,780)	136,932	(104,905)	113,014	100,808	50,818	64,708	57,795	52,882	41,670	37,388	33,413
Income tax savings if LAL imposed	45,810	38,793	50,875	46,532	45,534	57,973	27,823	26,152	25,583	18,455	15,761	13,303
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(256,837)	38,793	(171,478)	78,723	72,503	29,296	40,020	38,349	37,780	30,652	27,958	25,500
Increase (decrease) in cash flow	(49,057)	(98,139)	(66,573)	(34,291)	(28,305)	(21,522)	(24,688)	(19,446)	(15,102)	(11,018)	(9,430)	(7,913)
Effect of LAL on taxpayer in the 60-percent tax bracket:												
Income tax savings under present law	113,840	164,318	140,937	96,988	88,606	95,394	63,013	54,718	48,822	35,367	30,229	25,459
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(188,807)	164,318	(81,416)	129,179	115,575	66,717	75,210	66,915	61,019	47,564	42,426	23,656
Income tax savings if LAL imposed	54,972	46,551	61,049	55,838	54,641	69,568	33,387	31,382	30,700	22,145	18,913	15,963
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(247,675)	46,551	(161,304)	88,029	81,610	40,891	45,584	43,579	42,897	34,342	31,110	28,160
Increase (decrease) in cash flow	(58,868)	(117,767)	(79,888)	(41,150)	(33,965)	(25,826)	(29,626)	(23,336)	(18,122)	(13,222)	(11,316)	(9,496)
Effect of LAL on taxpayer in the 70-percent tax bracket:												
Income tax savings under present law	132,813	191,704	164,427	113,152	103,374	111,293	73,515	63,837	56,959	41,262	35,267	29,702
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(169,834)	191,704	(57,926)	145,343	130,343	82,616	85,712	76,034	69,156	53,459	47,464	41,899
Income tax savings if LAL imposed	64,134	54,309	71,224	65,145	63,748	81,162	38,952	36,613	35,816	25,836	22,065	18,624
Distributions (contributions)	(302,647)		(222,353)	32,191	26,969	(28,677)	12,197	12,197	12,197	12,197	12,197	12,197
Cash flow effect	(238,513)	54,309	(151,129)	97,336	90,717	52,485	51,149	48,810	48,013	38,033	34,262	30,821
Increase (decrease) in cash flow	(68,679)	(137,395)	(93,203)	(48,007)	(39,626)	(30,131)	(34,563)	(27,224)	(21,143)	(15,426)	(13,202)	(11,078)

as accelerated depreciation in excess of straight line are actual amounts for the years 1971–1975. For the years 1976–1981, the amounts were computed based upon the assets on hand at December 31, 1975 and assuming that no asset additions will be made.

(3) It is assumed that the project will be sold at the end of 1981. This will be 10 years after the project was placed in service. See #5 for sale assumptions used.

(4) Schedules are attached which show the tax effect and net cash flow for taxpayers in the 50%, 60% and 70% tax brackets. For each tax bracket, the following information is shown for the years 1970–1981: (a) Income Tax Savings Under Present Law; (b) Distributions made to Partners or Contributions made by Partners; (c) Cash Flow Effect under Present Law; (d) Income Tax Savings if LAL Imposed; (e) Distributions made to Partners or Contributions made by Partners; (f) Cash Flow Effect if LAL imposed; (g) Increase (decrease) in Cash Flow caused by LAL.

(5) Three separate sale assumptions were made: (a) Sale at $1 over the mortgage balance; (b) sale at 10 times projected cash flow; (c) sale at original purchase price.

(6) A rate of return on investment is shown for the 50%, 60% and 70% taxpayer, both under the present law and under the proposed law. In order to arrive at meaningful rates of return, an assumption must be made as to the interest rate which could be earned on the reinvested cash flow resulting from the project. It has been assumed that the cash flow resulting from tax benefits and distributions will be invested and earn a rate of 7% until the time the project is sold.

The payment of capital gains tax and minimum tax (using the newly proposed 14% rate) in the year of sale has been considered when computing the rate of return on investment. Also considered when computing the rate of return under the proposed law is the effect of the deductions previously deferred because of the LAL provisions. These deductions are allowable upon disposition of the property.

OIL AND GAS DEVELOPMENT DRILLING VENTURE, 2-WELL PROGRAM—$200,000 OTHER INCOME

	Year 1	Year 2	Year 3	Year 4	Year 5
A. Present law:					
Sales of oil	$66,000	$58,000	$52,000	$47,000	$41,000
Sale of property					205,000
Total revenues	66,000	58,000	52,000	47,000	246,000
Deductions:					
Intangible drilling costs	125,000				
Depletion		12,760	11,440	10,290	8,910
Lifting costs and depreciation	24,500	23,000	21,500	20,500	18,500
Total deductions	149,500	35,760	32,940	30,790	27,410
Income from oil operations	(83,500)	22,240	19,060	16,210	218,590
Other income	200,000	200,000	200,000	200,000	200,000
Total taxable income	116,500	222,240	219,060	216,210	418,590
Tax thereon [1]	55,410	126,550	124,320	122,330	145,240
Cash flow [2]	(10,910)	116,450	114,180	112,170	290,260
B. Under House bill (LAL :					
Revenues as above	66,000	58,000	52,000	47,000	246,000
Deductions:					
Intangible drilling costs	41,500	22,240	19,060	16,160	26,040
Depletion		12,760	11,440	10,340	9,020
Lifting costs and depreciation	24,500	23,000	21,500	20,500	18,500
Yotal deductions	66,000	58,000	52,000	47,000	53,560
Income from oil operat8ons					192,440
Other income	200,000	200,000	200,000	200,000	200,000
Total taxable income	200,000	200,000	200,000	200,000	92,440
Tax thereon (including preference tax) [1]	113,500	110,980	110,980	110,980	168,570
Cash flow [2]	(69,000)	132,020	127,520	123,520	266,930

[1] Tax calculations reflect capital gains element and preference taxes where applicable.

[2] Cash flow equals taxable income plus noncash deductions, income taxes and capital expenditures not currently deductible.

ASSUMPTIONS CONCERNING THE OIL WELL PRODUCTION DATA AND OTHER INCOME OF THE TAXPAYER

1. The price of oil used in the examples is $7.00 per barrel and has been applied to recoverable reserves in order to compute the annual revenues and sales proceeds from the properties.
2. The lifting costs on the properties are computed at the following percentage of gross revenues from production:

	Percent
Lease operating expense and production taxes	15–20
Overhead	10
Total	25–30

3. The reserves for which production has been computed in examples 2 and 3 have a 10 year life with a 10% declining production rate.
4. Lease and well equipment costs total $75,000 per well and has a 9½ year useful life, depreciable on a straight-line basis at $8,000 per year.
5. Cost depletion has been ignored since total leasehold costs is only $5,000 per example, and the effect on any single year's income or loss is nominal.
6. The production is from properties qualifying for the small producer exemption and is subject to the 65% limitation.
7. The taxpayer files a joint return and has an annual unearned taxable income from other sources as shown in the examples. No preference items arise from other sources, and the effect of income averaging has been ignored.
8. Investment tax credit and state income taxes have also been ignored.

WELL NO. 1

1. A well is drilled in Year 1 at the following cost:

Leasehold cost	$5,000
Intangible drilling	100,000
Intangible completion	25,000
Tangible completion	75,000
Total	205,000

2. Sufficient reserves are found to generate the following production:

Year 1	$44,000
Year 2	39,000
Year 3	34,000
Year 4	30,000
Year 5	26,000
Total	173,000

3. At the end of the 5th year the property (including equipment) is sold for $150,000 (50% of value of remaining reserves and the net book value of equipment).
4. The well is less than 2 miles from existing wells.

WELL NO. 2

1. A developmental well is drilled within 2 miles of existing production at the following costs:

Leasehold costs	$5,000
Intangible drilling	100,000
Intangible completion	25,000
Tangible completion	75,000
Total	205,000

2. Sufficient reserves are found to generate the following production:

Year 1	$88,000
Year 2	77,000
Year 3	70,000
Year 4	64,000
Year 5	56,000
Total	355,000

3. At the end of the 5th year, the property is sold for $260,000 (50% of value of remaining reserves, and the net book value of equipment).

April 12, 1976

The Honorable Russell B. Long
Committee on Finance
United States Senate
Washington, D. C. 20510

In oral testimony before the Committee on Finance on March 31, 1976, I outlined briefly certain proposals for changes in the Internal Revenue Code relating to capital formation. The statement which follows is the study on this subject to which I referred. We will appreciate inclusion of it in the record of the hearings being presently held by the Committee on Finance.

The statement presents our analyses and recommendations. It also demonstrates their possible impact on representative business entities in certain industries. In addition, the statement presents recommendations to enable the individual sector to participate in the formation of additional capital and to spread the ownership of such capital more widely among individual taxpayers.

This statement has been prepared on the basis of our experience and observations gained from our professional practice. The statement was not prepared on behalf of any of our clients nor with their approval or assistance. It is our policy not to appear on behalf of any client or clients.

If you, the members of your Committee, or your staff would like to discuss this statement or have any questions with respect to it, we would be pleased to respond at your convenience.

Respectfully submitted,

ARTHUR ANDERSEN & CO.

By DONALD M. GAMET

Donald M. Gamet,
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INFLATION, TAXATION, AND CAPITAL FORMATION *

INTRODUCTION

The macroeconomic aspects of the needs for capital in the United States in the near future have been well documented, widely discussed, and reported. Similar study has been given to the availability of capital to meet these needs. In almost all cases, the studies demonstrate that the needs for capital exceed the sources; thus, a "capital gap" will exist for most of the next decade.

More focus needs to be brought to bear on the impact of inflation on an individual enterprise in terms of its capacity to supply goods and services and employment opportunities and its needs for capital as well as the extent to which taxes can hinder or enhance the enterprise's capacity. In this connection, alternative means of stimulating the creation of necessary capital by the private sector must be considered.

As background, it is worthy to reflect somewhat on the overall economic environment in which the enterprise operates since its ability to fulfill its role in the economy is affected by these external economic forces.

Capital Needs

Although the estimates of capital needs vary, recent studies indicate that for the next decade $4.5 trillion is a reasonable estimate. Even more critical than the total needs are the estimates of the excess of capital needs over sources. Various factors influence these estimates, including the assumptions made for rate of inflation, population growth, environmental expenditures, and the Federal deficit or surplus. Recently, the total shortage for the next decade has been estimated to be as much as $1 trillion.

For the entire period since World War II, U.S. industry as a whole, and particularly the portion of it devoted to manufacturing, has been underinvesting in new facilities and in the modernization of old facilities, not only in relation to the amount needed to stabilize rising unit labor costs as a portion of total manufacturing costs, but also in relation to comparable investment in other industrial countries.[1] As a result, the average age of U.S. manufacturing plants has been increasing while that of many other important industrial nations has been

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1. GROSS DOMESTIC FIXED ASSET FORMATION AS A PERCENTAGE OF GROSS NATIONAL PRODUCT

Country	1960	1965	1970
United Kingdom	16.3%	18.0%	18.0%
Japan	30.2%	30.6%	35.1%
Italy	22.0%	18.8%	21.2%
West Germany	24.0%	26.6%	26.6%
Sweden	21.2%	22.8%	21.7%
Belgium	18.9%	21.8%	21.9%
France	20.2%	24.4%	25.8%
The Netherlands	23.6%	24.5%	26.3%
Canada	22.2%	23.8%	21.1%
United States	16.8%	17.2%	16.2%

*Appendixes A – L were made part of the official files of the Committee.

declining. The United States' competitive position in world markets has slipped badly in many industries.[2]

This "modern capacity" gap carried over from the past puts a special strain on available capital resources of the near future and further impedes the ability to improve real wages. When the cost of restoring modern capacity is added to the "normal" capital requirements needed to support additional people entering the labor market, the development of new technology, and the extraordinary needs inherent in the drive to protect the environment and develop energy resources, a formidable challenge in terms of capital formation is presented to the nation as a whole.

Capital Sources

In contrast to the rapid rise of the need for capital and the supply of new capital, savings has increased only moderately over the same post-World War II period, and the source of such savings has been changing drastically. Most important in these trends is that government deficits have been absorbing a growing portion of total savings, thus reducing the savings available for investment in productive facilities. The resulting diminution of private savings and corporate profits available as capital sources has required business to rely to a greater extent on capital recovery as a source of capital. Yet, in an inflationary era, this particular source of capital is incapable of providing for replacement of existing capacity and thus cannot serve as a source of capital for long-term growth and modernization.

It is obvious that the question of the availability and need for capital is an extremely complex one with a great many contributing factors including, conspicuously, the consumption patterns of both the private and public sectors in the postwar period. Among the conflicts which must be resolved is short-term consumption versus investment for long-term growth in the standard of living. It is also obvious that the anticapital bias of the Federal income tax structure and its interaction with inflation has been a major contributing factor to the growing shortage of capital.

Taxation of the Phantom Profits of Inflation Increases the Capital Gap

As the purchasing power of money deteriorates because of inflation, the assets of a business and the investor come to reflect the decline in the value of money by being stated in higher numbers of dollars. Correspondingly, debt and stockholders' equity also come to be stated in terms of the depreciated currency. Without the intervention of the income tax, and assuming none of the phantom profits were used to increase dividends, the relationships among these elements of the corporate balance sheet would undergo only minor change. Unfortunately, taxable income as defined by the Internal Revenue Code does not recognize

2. McGraw-Hill Publications Company, *How Modern Is American Industry?* (1974).
Competitiveness of U.S. Industries, United States Tariff Commission (1972).
The United States in the Changing World Economy, The Peterson Report, p. 7.

as a deduction for tax purposes the additional dollars required to maintain intact the capital of the enterprise. As a result, every business is decapitalized by one-half of the amount by which changes in the price level inflate the dollar value of its net assets while they are held. The net capital thus lost must be made up from after-tax profits or from some external source of new equity or debt to just maintain the initial capacity of the business in question. To the extent that the current tax burden of business is somewhat lightened by accelerated depreciation, investment credit, LIFO inventory valuation, etc., some offset exists; but these are not adequate to offset the taxes paid on phantom profits and to this extent are not available to meet either growth or modernization requirements. This can be quickly demonstrated as follows:

Total stock of equity capital invested in business at the end of 1972 in billions of dollars (latest data available)	$887.0
Rate of inflation—1974	10.2
Total capital erosion	$ 90.4
Tax effect at 48%	$ 43.4
Tax expenditures for business—1974—	
~~Foreign tax,~~ DISC, etc.	$ 1.3
Accelerated depreciation	.4
Investment credit	3.7
Total	$ 5.4

While full use of LIFO accounting would give recognition to between 30% to 40% of the capital erosion indicated above, its adoption has been limited by the difficulty in implementation. We would estimate that less than half of all inventories are accounted for under the LIFO method.

The social, economic, and political forces that led to this "capital crisis," together with the direct effects of the crisis, were undoubtedly contributing factors in bringing about the recent recession. The slow recovery, in turn, however, enormously complicates development of corrective actions. Although, in the long run, the cost of the capital shortage falls primarily on the employees and customers of business,[3] that fact is effectively buried by the direct short-range effects of inflation and recession on those same employees and customers, particularly at lower income levels. Consequently, although the long-range capital needs of business and the economic welfare of its employees and customers are parallel, short-range, and in the battle for public opinion, they tend to be diametrically opposed. Unfortunately, unless a way is found to reconcile the two views, any effort to improve the total economy is likely to fail.

3. *Tax Policy, Capital Formation and the Growth of Productivity*, a report prepared for the National Association of Manufacturers.

The Economic Challenges

Today among the great challenges facing the United States are to:

1. obtain, as soon as possible, the increase and modernization of productive facilities required to restore productivity to a competitive level, to help create the supply of goods and services needed to combat inflation, to reduce unemployment, and to permit the continued rise in real wages anticipated by the working public, thus enabling all to continue to improve their standard of living;

2. generate the savings required to finance this investment so that it is not accommodated by further expansion of the money supply, thus contributing to inflationary pressures; and

3. achieve a wider distribution of the ownership of the nation's capital so that more people can share in the benefits provided through the ownership of capital and reduce the short-term conflicts of interest which inhibit effective political action on the issues.

A Partial Solution—Tax Reform

Meeting these challenges will require a significant shift in priorities so as to generate additional capital for investment through:

1. increased saving by the general public,
2. increased capital formation in the corporate sector, and
3. the reduction of Federal deficits.

It is imperative that a part of the growth in consumption in each sector must, for a time, be diverted to the formation of capital if the national long-range objective of increased real growth in the economy is to be attained. While achievement of these objectives cannot be accomplished solely by income tax reform, it can remove many of the biases against capital formation.

Depending upon the amount of time it takes newly formed capital to be reflected in the GNP, some Federal expenditures need to be deferred until the revenues generated by the growth in the economy and tax base are realized by the Treasury. To do otherwise would be counterproductive since increasing the deficit either adds to inflation or reduces the portion of new capital available to industry. In the evaluation of these alternatives and their impact on the Federal revenues and expenditures, more consideration must be given to these two facts:

1. Every person who owns an insurance policy or savings account, participates in a pension or profit-sharing plan, or holds any other type of investment property already has a direct stake in the welfare of the private sector. This stake will grow even more if proposals to broaden ownership of capital are adopted.

2. Every increase in the rate of inflation imposes an indirect tax in the form of reduced purchasing power. This indirect tax is extremely pernicious as it strikes most severely those persons having the least discretion in their expenditure patterns. To attempt to alleviate this tax by redistribution of income is, over the long term, destructive because, for the most part, redistribution merely converts the stock of capital into consumption.

It is readily apparent that the present tax incentive programs have been extremely helpful in supporting the growth in productive capacity; however, these incentives are not adequate to meet the demands which must be met if the full-employment objective is to be achieved. We believe that the challenge faced by the country can be met and that modification of the tax system to encourage savings and diminish the conversion of capital into consumption can be an important tool for meeting the challenge. With this view in mind, we would propose for consideration certain modifications of the tax system. Due to the impact on revenue, some of these proposals will of necessity require some time before full implementation can be achieved; however, the sooner such implementation can be achieved, the sooner the tax system will enhance the ability of the country to generate capital. The full implementation of these recommendations will also permit considerable overall simplification of the tax statutes.

We would suggest that two approaches being followed to some extent in other countries be considered as a starting point for the reform of the taxation of corporate profits.

1. Allowance of a deduction for the amount required to maintain intact the real capital of the enterprise. This deduction should substantially eliminate taxation of the phantom profits of inflation.

2. Integration of the corporate and shareholder tax structure through the allowance of a deduction for dividends paid reducing the extent of double taxation of corporate profits which presently exists.

As will be demonstrated in subsequent sections of this statement, each of these proposals can enhance the ability of U.S. business to provide goods, services, and job opportunities. Each of these is susceptible to phase-in over a reasonable time frame.

Further improvements must also be made to reduce the anticapital bias inherent in the present tax system. This bias combined with the effects of inflation serves to spur consumption at the cost of capital formation. Properly structured tax reforms which will reduce the anticapital bias should generate savings many times the amount of the short-term tax revenue loss. These savings will, over the long term, generate even greater revenues through growth of the total tax base. It is important that such reforms be structured to provide incentives to all taxpayers. Such reforms, to be successful, must produce large

results from the middle and upper income taxpayers who are presently most able to save. They must also provide generous incentives for saving at the lower income levels to achieve, over a period of time, a wider ownership of the nation's productive facilities.

Here again, we have turned to other countries as well as to the historical development of our own tax system to observe techniques presently being used and selected, some of which would seem to be most responsive to the country's needs as a starting point. These are as follows:

1. additional incentives for savings including tax deferrals,
2. deferral of tax on capital gains until funds are withdrawn from capital investment, and
3. taxation of real capital gains not reinvested at ordinary rates.

A technique which can take many forms is to provide for the deferral of tax with respect to amounts saved. This concept is not new as it already underlies tax provisions relating to qualified pension plans, profit-sharing plans, ESOPs, and IRAs. The principal limitations of these present concepts are that they are tied to certain limited forms of income and do not provide generally for direct voluntary contributions by the employee-taxpayer of pretax income over and above that contributed by the employer. An expansion of this concept would permit taxpayers to claim a deduction for any net savings or investment. Any net withdrawal would be taxed in the year in which it occurs. This is an extremely flexible approach which can be readily modified to stimulate savings in various sectors as well as for specific types of investment and which can be tailored to obtain different relative benefits at different levels of income. Properly developed, this technique can be used in conjunction with existing pension provisions to lessen the future burden on the Social Security System and inhibit any further growth of the nearly $2 trillion unfunded cost. The administration proposals for the Broadened Stock Ownership Plans and the utility dividend reinvestment plan are techniques for implementing this concept in a limited manner. However, it would be desirable to structure such a proposal more broadly to involve wide cross sections of the nation's taxpayers in the effort to increase capital formation.

It is inconsistent with the objective of generating capital to tax capital gains if the proceeds are entirely reinvested in the capital markets; to do otherwise merely directs resources from capital to consumption by way of the U.S. Treasury. The tax on the gain should be deferred to the extent the proceeds are reinvested.

When the gain is ultimately realized, its taxation should adequately recognize the effect of inflation and the problem of income bunching in the year the income is reported.

Finally, the taxation of an estate should be modified to provide for carry-over to the heirs of the decedent's tax cost basis. The capital gains realized by the heirs should be taxed as described previously.

One final but important consideration should be the simplification of the tax law. As we have expressed a number of times, the increasing complexity of the tax law is a matter of great concern. Unless the trend is reversed, the public's confidence in the basic fairness of the system will evaporate which will lead to a breakdown of honest self-assessment of taxes by the public. These risks must be eliminated as quickly as possible.

The proposals made above will, when fully implemented, provide a basis for significant simplification. The elimination of special categories of income and many inflation-related relief provisions can then be accomplished without damage to any part of the economy. Long-term objectives of equity in taxation and the elimination of many so-called "loopholes" can also be achieved without serious disruption of any sector of the economy.

THE IMPACT OF INFLATION AND TAXATION ON A BUSINESS ENTERPRISE—A DEMONSTRATION

Modeling techniques seem to be the most practical way of demonstrating the impact of inflation and taxation on a business enterprise and how these interacting forces affect an enterprise's ability to provide goods and services and employment opportunities. The application of these concepts at the corporate, or microeconomic, level is intended to complement studies made at the macroeconomic level, thus focusing on the impact on a representative business, employer, or group of employees. The techniques are also used to demonstrate the anticipated impact of certain of the above proposals.

Two model companies were developed as representatives of the broad spectrum of the U.S. business community. The two industries represented are the electrical manufacturing industry and the primary metals industry. The electrical manufacturing industry includes manufacturers of small appliances and other electrical machinery such as radio and TV equipment and hardware tools. This industry may be characterized as consumer oriented, labor intensive, and innovative. Its product may quickly become obsolete and, thus, modernization is constantly required to remain competitive. Companies in these industries tend to have high working capital requirements for inventories and accounts receivable and their equipment is subject to shorter depreciable lives.

The primary metals industry includes steel, aluminum, copper, and other metal-working companies. These companies may be characterized as capital intensive with long-lived equipment and industrial customers. Any real changes in productivity in a basic industry such as this will be reflected in the price of all goods in which its output is used.

In developing the models, we have defined certain relationships among the various factors which influence the company's activities, including the relationships between sales

and expenses, between income and cash flow, between income and dividends, between working capital and sales, and between long-term debt and equity. Based on our experience, we believe the relationships to be reasonable and representative of the relationships within each industry. The detailed assumptions are listed in Appendix A.

Four cases were developed in each of the industries to demonstrate the effect of inflation and the proposed tax reforms. In the first case, the actual tax incentives and inflation rates in effect during the 1965-1974 historical period were used for the ten-year test period. In the second case, the annual inflation rate was increased to 8% for the ten-year period (versus an average 4% actual inflation rate). The results of the second case can be compared to those in the first case to better isolate the effects of inflation and to provide a basis for evaluating the adequacy of current tax incentives in a period of high inflation. The third case reflects the allowance to the company of a tax deduction for the loss of purchasing power through inflation by a "capital maintenance deduction." This deduction is the amount derived from applying the annual inflation rate (8%) to the average stockholders' equity of each company. In the fourth case, it was assumed the shareholder and corporate tax burden have been integrated through the allowance of a deduction for dividends paid, again in a period of 8% inflation.

The four studies confirm our conclusions that inflation impairs the ability of an enterprise to supply goods and jobs. Further, sound tax policy which avoids the taxation of phantom profits and enhances the ability of the enterprise to attract necessary capital can overcome some of the burdens imposed by inflation. The following table summarizes the results of the four cases:

	Beginning Data			
	Electrical		Primary Metals	
	Capacity Units	Employees	Capacity Units	Employees
All cases	1,000	8,900	1,000	4,668

	Results After Ten-Year Period			
	Electrical		Primary Metals	
	Capacity Units	Employees	Capacity Units	Employees
Actual inflation—				
Present tax incentives	1,687	12,774	1,063	2,949
Assumed 8% annual inflation—				
Present tax incentives	1,372	10,333	951	2,648
Capital maintenance deduction	1,775	12,783	1,102	3,000
Dividends paid deduction	1,673	12,176	1,009	2,786

The tax reforms proposed here only help to recover, under high inflation, the actual growth rate experienced during the 1965-1974 period of moderate inflation. However, it should also be specifically noted that none of these cases results in a 6% annual growth rate which is regarded as necessary by many economists if full employment is to be achieved.

Impact of Increase in Rate of Inflation

The operations of each of the two businesses were analyzed for a ten-year period, assuming both actual inflation rates in existence during the years 1965-1974 and an assumed 8% annual rate of inflation. The results of this analysis are attached as Appendices B through I. The financial position of each company at the beginning and the end of the test period can be summarized as follows:

Electrical Industry*

	1965-1974 Actual Inflation			Assumed 8% Annual Inflation	
	Year 1	Year 10	Increase	Year 10	Increase
	(Millions of Dollars)				
Working capital	$35.7	$ 81.9	$ 46.2	$ 91.0	$ 55.3
Other assets	11.6	40.9	29.3	45.6	34.0
Net plant	24.1	51.9	27.8	53.0	28.9
Total	$71.4	$174.7	$103.3	$189.6	$118.2
Long-term debt	$11.8	$ 46.9	$ 35.1	$ 51.1	$ 39.3
Deferred taxes	3.1	6.1	3.0	5.7	2.6
Equity	56.5	121.7	65.2	132.8	76.3
Total	$71.4	$174.7	$103.3	$189.6	$118.2
Productive capacity—					
Units	1,000	1,687		1,372	
Annual rate of growth		5.37%		3.21%	

* Detailed data at Appendices B and C.

Primary Metals**

	1965-1974 Actual Inflation			Assumed 8% Annual Inflation	
	Year 1	Year 10	Increase	Year 10	Increase
	(Millions of Dollars)				
Working capital	$27.0	$ 39.2	$12.2	$ 48.3	$21.3
Other assets	9.1	25.5	16.4	31.4	22.3
Net plant	48.7	79.6	30.9	79.9	31.2
Total	$84.8	$144.3	$59.5	$159.6	$74.8
Long-term debt	$15.3	$ 36.5	$21.2	$ 40.8	$25.5
Deferred taxes	5.7	10.2	4.5	9.8	4.1
Equity	63.8	97.6	33.8	109.0	45.2
Total	$84.8	$144.3	$59.5	$159.6	$74.8
Productive capacity—					
Units	1,000	1,063		951	
Annual rate of growth (decrease)		.61%		(.50%)	

The results of operations developed for the ten-year period can be summarized as follows:

	Electrical		Primary Metals	
	Actual Inflation	Assumed 8% Annual Inflation	Actual Inflation	Assumed 8% Annual Inflation
	(Millions of Dollars)			
Sales	$2,611.7	$2,933.7	$1,430.9	$1,711.0
Operating expenses	(2,324.4)	(2,610.9)	(1,259.2)	(1,505.7)
Depreciation	(61.4)	(56.9)	(72.0)	(69.7)
Income before taxes	$ 225.9	$ 265.9	$ 99.7	$ 135.6
Federal income taxes	(108.4)	(127.7)	(40.0)	(54.2)
Investment tax credit	3.2	3.0	3.7	3.6
Net income	$ 120.7	$ 141.2	$ 63.4	$ 85.0

The financial position of the two model companies at the end of the ten-year period under 8% inflation generally reflects the effects of the high rate of inflation. Each category of assets has grown; however, in both cases, under conditions of 8% inflation, the productive capacity at the end of ten years was less than it would have been under actual inflation. Due to the high rates of inflation, the rapid increases in cost of equipment, and the limitation in

** Detailed data at Appendices F and G.

ability to obtain capital, the model companies are unable to replace and increase their stock of productive capacity as rapidly as they did under actual inflation.

The increased investment in assets was financed as follows:

Electrical Industry

	Actual Inflation		Assumed 8% Annual Inflation	
	(Millions of Dollars)			
Increase in long-term debt	$ 35.1	34%	$ 39.3	33%
Increase in tax deferral due to accelerated depreciation	3.0	3	2.6	2
Investment credit	3.2	3	3.0	3
Net income before investment credit but after dividends	62.0	60	73.3	62
Total	$103.3	100%	$118.2	100%

Primary Metals

	Actual Inflation		Assumed 8% Annual Inflation	
	(Millions of Dollars)			
Increase in long-term debt	$21.2	36%	$25.5	34%
Increase in deferral due to accelerated depreciation	4.5	7	4.1	5
Investment credit	3.7	6	3.6	5
Net income before investment credit but after dividends	30.1	51	41.6	56
Total	$59.5	100%	$74.8	100%

The total amount of increased capital required in a period of 8% inflation is consistent with the higher unit costs and sales prices. However, it must be noted that a lesser proportion of the additional dollars was provided by both deferred taxes and investment tax credit. More of the capital required due to the increased rate of inflation was provided by incurring additional debt or retaining operating earnings.

The results demonstrate that the current primary tax incentives of accelerated depreciation and investment tax credit are inadequate to permit business to maintain or increase productive capacity in periods of high inflation. Further, they provide no real assistance in modernizing the U.S. industrial plant to permit it to compete more effectively in world markets.

It should be noted that the adoption of the LIFO method of accounting for inventory would have lessened the impact of the increase in the inflation rate to 8%. However, limitations arising from LIFO accounting inhibit the conversion to LIFO by business. The impact of these negative factors by industry has not been quantified and, thus, no reasonable assumption could be made as to what percentage of the inventory would have been recorded at LIFO during the 8% inflation period.

The tables also show the importance of net income as a source of capital in periods of high inflation. In considering this aspect, it must be emphasized that the model assumes all production can be sold each year for this higher price (8% higher per year). For many industries, however, the demand curve may not be sufficiently elastic to permit the yearly price increase and, to that extent, the business will be even less capable of generating capital to maintain its position in the total economy.

The effects of inflation are further emphasized by comparing the amount of productive capacity which can be acquired using the available cash.

Ten-Year Summary of Cash Available for Investment

	Electrical Industry			Primary Metals		
	Actual Inflation	Assumed 8% Annual Inflation	Percent Decrease	Actual Inflation	Assumed 8% Annual Inflation	Percent Decrease
Total cash available to purchase additional capacity	$89.2	$85.8	−4%	$102.9	$100.9	−2%
New units of capacity purchased	1,274	959	−25%	568	457	−20%

The table demonstrates two points: not only does inflation decrease the capacity which can be purchased with available cash flow, but inflation also decreases the cash flow available because significant additional amounts must also be invested in current assets as inventories and receivables.

To this point, the results developed have been analyzed in the abstract terms of dollars and units of production. Using historical relationship of sales, as adjusted for inflation, per employee, the following results in level of employment would be experienced:

Summary of Growth in Capacity

	Capacity		
	Year 1	Year 10	Annual Rate of Growth (Decrease)
Electrical—			
Actual inflation	1,000	1,687	5.4%
Assumed 8% annual inflation	1,000	1,372	3.2%
Primary metals—			
Actual inflation	1,000	1,063	.6%
Assumed 8% annual inflation	1,000	951	(.5%)

Summary of Growth in Employment

	Employees		
	Year 1	Year 10	Annual Rate of Growth (Decrease)
Electrical—			
Actual inflation	8,900	12,774	3.6%
Assumed 8% annual inflation	8,900	10,333	1.5%
Primary metals—			
Actual inflation	4,668	2,949	(5.6%)
Assumed 8% annual inflation	4,668	2,648	(7.3%)

The results support the basic fact that, as modernization occurs (and industries become more capital intensive), it simply takes more units of productive capacity to support the employment of an individual. This fact is also the basis on which employees can continue to improve wages in terms of real purchasing power as this level of investment supports improved employee productivity. As shown earlier in the discussion, if the cash flow under high inflation does not permit the addition of capacity, it will have the further effect of reduced job opportunities. This is demonstrated, for example, in the model electrical business: the 8% inflation resulted in a 40% decrease in the rate of growth of capacity but a 60% decrease in the rate of growth of employment.

In recent months, it has been stated by a number of economists that the economy must expand at an annual rate of 6% in real terms over the next five years in order to produce the two million new jobs yearly for new entrants to the labor force and to keep unemployment at reasonable levels. Neither industry modeled achieved this growth even during the "non-inflationary" 1960s, and the data developed show that even slower real growth occurs in periods of high inflation due to limits in the available supply of capital. Companies need more capital during inflation to purchase the same units of capacity. As modernization occurs, each unit of capacity employs fewer workers. This increase in productivity will be moderated somewhat by the increase in the capital expenditures for nonproductive pollution control facilities. Our model shows that in some industries the current tax incentives do not even provide the internally generated capital needed to maintain constant levels of employment. The lack of growth in capital and its corresponding effect on capacity must be viewed by the public and legislators as being directly related to jobs and unemployment.

Deductions for Capital Maintenance

Corporations are generally viewed as ongoing entities with an indefinite life. This view is one cornerstone upon which many aspects of corporate law, financial accounting, business decision making, and taxation of corporations are based. For the present at least, financial accounting and tax laws are founded on a cost concept which, in a period of little or no inflation, results in a profit determination which approximates real economic earnings or profits. Under the ongoing-entity assumption, as a corporation's assets are converted to cash, they will be replaced. If there has been no inflation, the cash recovered through operation should be adequate to purchase the replacement asset. A firm which

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has revenues only equal to costs will have the same equity at the beginning and end of an asset's life cycle and will be able to purchase the replacement assets to continue the next cycle.

In an inflationary period, however, the replacement asset will cost more than the asset consumed. In this circumstance, the break-even company referred to above will not have sufficient capital from its own resources to purchase the replacement asset and will soon find itself unable to function.

In an inflationary period, financial or tax profits based on the cost concept are overstated by phantom profits caused by inflation. The allowance of a "capital maintenance deduction" in the determination of taxable income is a method of reducing these illusory financial earnings to the real economic earnings which should be the basis for taxation. The "capital maintenance deduction" which would recognize the loss of ability to replace capacity could be measured by applying an inflation index to the average stockholders' equity for a given taxable year. The amount so determined would measure the additional capital required to maintain intact the company's productive capacity.

In order to demonstrate the effect of the allowance of this deduction, the assumptions based on the development of the model companies were changed to eliminate accelerated depreciation and investment credit and to reflect the allowance of the capital maintenance deduction described above in a period of 8% inflation. The results are summarized below:

Ten-Year Summary Based on the Allowance of a Capital Maintenance Deduction*

	Actual Inflation/ Present Tax Incentives	Assumed 8% Annual Inflation	
		Present Tax Incentives	Capital Maintenance Deduction
PRODUCTIVE CAPACITY:			
Electrical—			
Units	1,687	1,372	1,775
Annual rate of growth	5.4%	3.2%	5.9%
Primary Metals—			
Units	1,063	951	1,102
Annual rate of growth/(decrease)	.6%	(.5%)	1.0%
EMPLOYMENT:			
Electrical—			
Employees	12,774	10,333	12,783
Annual rate of growth	3.6%	1.5%	3.6%
Primary Metals—			
Employees	2,949	2,648	3,000
Annual rate of (decrease)	(5.6%)	(7.3%)	(5.3%)

* Detailed data at Appendices B, C, and D.

The allowance of this type of deduction would greatly enhance the ability of business to finance the growth necessary to achieve higher employment. Significantly, this model also demonstrates that, for some time, present incentives may need to be continued as in no case was a 6% rate of growth achieved and, thus, additional sources of capital are needed.

Dividends Paid Deduction

During the past few years, the percentage of investment funds flowing into equity capital has declined. Among the many reasons given for this trend is that the return on equity securities is not commensurate with the underlying risk and, thus, the available funds have been moving into other types of investment. The present double taxation of corporate profits limits the ability of an enterprise to provide an adequate return on equity investments. Further, the proportionately heavier tax burden which must be met before an adequate return is provided on equity capital causes some upward movement in prices which would not otherwise exist. Since the present corporate tax rates approximate 50%, two dollars of profits are necessary to pay one dollar of dividends. Thus, on a pretax basis, the return which needs to be earned on productive capacity financed by equity is doubled. Similar profit rates are needed to generate the earnings which must be reinvested in the business. These combined requirements impose a burden both on the corporation and the ultimate consumer.

In addition, it has been amply demonstrated by others that the result of double taxation significantly increases the proportionate tax burden borne by equity investors in the lower tax brackets.[4]

One way to better enable business to attract equity funds is to provide for integration of corporate and shareholder taxation. There are numerous methods of integration; however, the simplest is to merely eliminate the tax burden to the extent the income is distributed to the individual shareholder. This is most easily accomplished by allowing the corporation a deduction for any dividends paid.

The aforementioned approach could contribute to the formation of increased capital by the enterprise in a number of ways. First, all of the tax benefits could be retained by the corporation as, in effect, a direct contribution to equity capital. A better result might be obtained if the benefit were shared with the stockholder in the form of increased yield on his investment. This latter approach may be most advantageous as an improvement in dividend yield may enable the stock price to rise to a level at which the sale of additional equity securities is feasible. These additions to equity capital are important to the extent that they also support additional debt financing. In an industry in which one-to-one debt equity ratio is the norm, each dollar of equity capital retained or obtained as a result of this deduction will support one additional dollar of debt financing.

4. *Statement of Tax Policy, Elimination of the Double Tax on Dividends*, AICPA, 1976.
"A Look at the Capital Formation Issue," *Tax Notes*, Volume IV, Issue 7, February 16, 1976.

It is quite difficult to ascertain with any certainty the magnitude of additional capital which can be generated as the value of equity securities is affected by not only yield, but by a host of other factors including industry potential and growth. For purposes of this study, we have limited the equity effect to that generated by retention of part of the benefit. In the model, it was assumed that approximately half of the benefit of the deduction would be distributed to the shareholders as an additional dividend and the balance would be retained. The net increase in equity is assumed to support a proportionate amount of additional debt. As can be seen from the following data, even under these conservative assumptions, a very significant benefit can be realized:

Data Based on Dividends Paid Deduction

	Actual Inflation/ Present Tax Incentives	Assumed 8% Annual Inflation	
		Present Tax Incentives	Dividends Paid Deduction
		(Millions of Dollars)	
Increase in long-term debt and stockholders' equity—			
Electrical	$100.3	$115.6	$158.2
Primary metals	$ 55.0	$ 70.7	$ 85.9
Productive capacity—			
Electrical—			
Units	1,687	1,372	1,673
Rate of growth	5.4%	3.2%	5.3%
Primary metals—			
Units	1,063	951	1,009
Rate of growth/(decrease)	.6%	(.5%)	.1%
Employment data—			
Electrical—			
Employees	12,774	10,333	12,176
Rate of growth	3.6%	1.5%	3.3%
Primary metals—			
Employees	2,949	2,648	2,786
Rate of (decrease)	(5.6%)	(7.3%)	(6.6%)

The above data shows that the dividend deduction has generated sufficient additional capital to enable the enterprise to recover a significant part of the capacity loss caused by inflation. At the same time, it has significantly increased the income flowing to individual taxpayers/shareholders. The data also demonstrates that neither of the proposed changes is adequate alone, and, thus, a combination is needed if national economic goals are to be achieved.

Other Aspects of Corporate Tax Reform

Both of the suggested changes in the taxation of corporate business are directed at neutralizing some of the anticapital bias in the Internal Revenue Code. Present incentives will clearly have to be retained, at least in part, during the phase-in period if these proposals are adopted. Thereafter, Congress would need to make a separate decision as to whether the total capital formation needs of the nation or the needs of any specific segment require a continuance of present incentives.

IMPROVEMENT OF CAPITAL GENERATION BY INDIVIDUALS

The tax incentives and capital allowances presently available to business and the magnitude of the problems involved in maintaining, from its own resources, business capacity to produce goods and employ people make it obvious that there are very practical limits to the additional capital that can be made available from internal sources.

Personal Savings Must Be Increased

Personal income represents more than 80% of the GNP, and personal income taxes represent over 60% of total Federal revenue exclusive of Social Security and unemployment taxes. It is clear that the capital gap can be closed only by drawing from this source. Accordingly, a top priority of tax reform should be the enactment of proposals that encourage personal savings initially and do not diminish the stock of capital thus formed by levying taxes biased against such savings. An increase in personal savings is also essential to attaining the objective of a broader distribution of the ownership of the stock of capital and the reduction of the current ideological conflict between current consumption and adequate capital formation.

A brief example can demonstrate the bias against savings which exists in the current tax system. Assume an individual would regard a new automobile or an income stream of approximately $240 per year as having equal value. If there were no taxes, the individual could, assuming a 6% return, either purchase a $4,000 automobile or the $240 income stream. If a 25% income tax is imposed, one-third more pretax earnings are required to acquire the income stream than the automobile. The above example can be summarized as follows:

	Without an Income Tax		With a 25% Income Tax	
	Automobile	Annual Income of $240	Automobile	Annual Income of $240
Pretax earnings	$4,000	$4,000	$5,334	$7,112
Income tax	—	—	1,334	1,778
Spendable income	$4,000	$4,000	$4,000	$5,334
Annual return at 6%		$ 240		$ 320
Tax thereon		—		80
Desired return		$ 240		$ 240

It can be seen that the imposition of the income tax significantly reduces the benefits of savings. With a 25% income tax, it takes more than a 75% increase in earnings to generate the same income stream. However, it takes only a 33% increase in earnings to purchase the same automobile. The magnitude of this bias against saving becomes more apparent when the effects of inflation are considered. Consider the same individual who decided to defer the purchase of the automobile and instead invest his money in the stock market. Even if the growth in value of the investment kept pace with inflation, upon disposition of the stock, the increase in value realized would be subject to capital gains tax. Thus, the individual's real principal investment would be diminished by the capital gains tax (decapitalization). Whether the dividend yield, net of tax, is sufficient to replace the capital lost through decapitalization and to compensate the individual for deferring consumption would be dependent on the yield realized in the particular investment. In most cases, the reward has not been adequate for this purpose. This effect is even more devastating if the investment has been in a fixed principal security. Only in unusual circumstances in the United States is there sufficient motivation to defer consumption and incur investment risk, especially in a time of inflation.

Relationship of Taxation to Personal Savings

The rate at which private savings are generated in an economy is a function of many variables. Among these variables are the rates of return available, the risks involved, and the extent to which savings is a part of the socioeconomic tradition of the society. A key factor affecting the rate of return earned on savings is the severity of the tax imposed on the income earned from the savings.

In an attempt to determine the relationship between savings rates and incentives for saving provided by the tax laws of ten other industrial nations, material has been gathered from sources within each such country concerning incentives which affect savings. While few nations have systems for collecting and analyzing national economic statistics comparable to the United States, sufficient data exists to suggest that the provisions of the tax systems of these nations may influence the rate of personal savings. For example, in a country such as Japan which has a high level of savings, a married couple may have up to $20,000 in savings

accounts on which the interest would not be taxable. In addition, the spouse may also qualify for deferral of interest on an additional $16,000 through an employer savings plan.

The attached Appendix J summarizes personal savings as a percent of the GNP for ten countries and the United States for the last ten years or for the time period for which data are available. The savings rate of each of the ten countries (except Canada) is much higher than the rate in the United States. Attached as Appendix K is a table summarizing the tax incentives for savings within the same ten countries.

Tax Incentives Must Encourage Savings and Discourage Consumption

Increased capital formation can only come from increased production and/or from decreased consumption. Since increased production is in turn largely dependent on increased capital, the initial stages of a program to improve capital formation must obviously stimulate savings and discourage personal consumption. Unfortunately, as has been illustrated above, an income tax on individual taxpayers operates to discourage savings. Accordingly, an objective of tax reform ought to be to ultimately substitute as the basis for taxation the conversion of income or capital to consumption rather than the realization of income. An equally important objective should be the elimination of those aspects of the tax that directly reduce capital already formed.

Long-Range Objective—Major Revision of Tax System

The achievement of these objectives would require a drastic restructuring of the revenue system and a long period to accomplish. These facts need not, however, delay the recognition and acceptance of the objectives and the taking of the necessary steps to phase in reforms consistent with them.

The above-described objective can be achieved if a few basic concepts are structured into the tax law.

- Income diverted from consumption to savings should be eligible for a deferral of tax until such income is returned to consumption. Included within this concept may be such items as BSOPs, ESOPs, dividend reinvestment proposals, and individual retirement accounts. A broader concept which will be discussed below would include a deduction for all types of savings which would be available to all taxpayers.
- Transactions which do not convert capital to consumption should not be taxed at all. This concept would be enacted by providing for the deferral of tax on capital gains if reinvested and the modification of estate and gift taxes.
- Recognize the impact of inflation and tax real gains only.

Each of these concepts is developed in greater depth in subsequent sections of this statement.

In order to enhance efficiency, equity, and neutrality in connection with the adoption of the above proposals, we would recommend that certain other tax proposals presently being considered also be adopted over a similar time period, including:

1. taxation of all income at ordinary rates,
2. substitution of direct subsidies for tax exemption of municipal interest, and
3. indexation of tax brackets.

Individual Deduction for Savings

Since savings is both an important source of capital for industrial growth and a factor in retarding inflationary pressure, individual taxpayers should be allowed a deduction or credit for amounts "saved."

Savings, as proposed, would be broadly construed to allow for maximum flexibility within the capital markets. In order to ensure this result, certain provisions of the tax law which have the effect of creating artificial biases for certain categories of investment would be repealed. In addition, new provisions could be enacted to allow the lower and middle income individuals to effectively consolidate funds in order to invest in vehicles not presently within their range. The implementation of this deduction or credit should help offset the effects of inflation and provide additional capital sources for industry at a minimal long-term net cost to the Treasury.

The deduction or credit for savings should be designed to generate the highest possible increase in individual savings rate per dollar of tax revenue deferred or foregone.

The U.S. Congress has legislated numerous incentives to encourage capital investment through such provisions as the investment tax credit and the Asset Depreciation Range. However, the incentives enacted by Congress do not generally reach the vast group of individual taxpayers who represent the largest potential source of new capital. The allowance of a tax deduction or credit for savings, together with the deduction for dividends paid to shareholders as proposed elsewhere, will significantly enhance the taxpayers' ability and desire to contribute to the formation of capital.

The American consumer, with his substantial amount of disposable income, should be encouraged to support the country's enormous capital requirements. Despite the income resources available for investment, the savings rate in this country compares unfavorably with other Western nations, many of which have adopted tax policies to promote increased individual savings (Appendix K). The proposal to provide a deduction or credit for "savings" should have a beneficial and perhaps dramatic impact on shifting the emphasis of the American consumer from consumption to savings with long-range benefits to the American economy. This shift may accelerate further the broadening of the ownership of capital which is vital to the continued enjoyment of economic and political stability.

The deduction or credit for savings should lessen the need for tax-sheltered investments, and the mass of proposed legislation designed to combat the abuses (LAL, etc.) would be unnecessary. The savings deduction or credit will also afford to the "middle class" taxpayer some of the benefits of the tax system presently reserved to the affluent sector.

The allowance of a corporate dividends paid deduction, which is proposed earlier, would generally make equities more competitive with corporate debt securities in the capital markets. The growth in the total supply of capital should also tend to alleviate the pressures on the debt markets, reducing not only the interest rate on corporate debt but also on Federal borrowings. The ability of the Federal government to borrow to meet its enormous requirement for money should be improved by the proposal since additional funds would be available through the savings deduction or credit.

In order not to disrupt any of the American capital markets, the proposal to provide a deduction or credit for savings should be designed to be neutral as to type of investment and to permit maximum flexibility in the flow of capital. In conjunction with the proposal to allow partial integration vis-à-vis the dividends paid deduction, a general neutrality as between debt and equity securities would be realized. The exclusion from gross income for interest on municipal obligations should be revoked and replaced with direct Federal subsidies to State and local governments. If the exclusion is not repealed, then an investment in municipal obligations should not qualify for the deduction or credit for savings.

The characterization of all income from whatever source derived should be uniform. Consistent with the objectives, the concession granted in the tax rate structure to certain gains derived from capital assets and assets used in business should be eliminated together with the deduction for 50% of net gains. Required by this overall objective is the need to eliminate from the determination of investment gains the artificial gains reflecting inflation. This could be accomplished by excluding the inflation effect from the determination of investment gains and indexing tax rate schedules to an appropriate economic indicator.

The allowance of a deduction or credit for savings could be easily structured in the form of the Individual Retirement Accounts (IRA) provided for in recent legislation. The concept could be expanded to provide for Tax Deferred Investment Accounts (TDIA). Any taxpayer could open a TDIA in any of the present financial institutions and direct the institution to invest the balance in the account in a certain manner. All income from the investment could be retained in the TDIA. Upon withdrawal from the TDIA, the taxpayer would report the withdrawn amount as ordinary taxable income. The amount subject to tax would be adjusted based on the length of time invested to recognize the impact of inflation. The tax on such amount could be computed in a manner consistent with that allowed for lump-sum distributions from qualified plans; this tax is based on an averaging concept to avoid the effects of "bunching." The dollar amount of the deduction could be limited to a fixed amount or a graduated percentage of increases in savings over a base amount. In order to provide or create incentive to those in the lower brackets, a credit

in lieu of a deduction could be allowed. This credit would not be recapturable if the funds were left on deposit for some minimum period. For the sake of simplicity, an account would become a TDIA merely by so designating it. Penalty taxes could also be assessed for early withdrawal from such accounts. In summary, the plan would be broad based, flexible, simple in operation, and completely neutral as to type of investment.

In order to accomplish the objective of creating a vehicle for all income groups to accumulate savings and to broaden investment opportunities, the administration has recommended the broadening of stock ownership through what has been referred to as a BSOP. The BSOP proposal, if successful, would contribute to the economic growth of the country by increasing capital investment. It should also, by opening the opportunity for investment to more people, contribute to improving the social and political stability of the free enterprise system. While the present administrative proposals are based on equity investments, they provide a step in the direction of allowing a broad-based savings deduction plan.

The ESOP technique, while limited to employees of corporations, is also an excellent technique for encouraging savings as well as for relating the employees' economic well-being with that of the employer. This approach can lead to improved productivity and better management/labor relations as all will be part owners of the enterprise.

Deferral of Taxation on Capital Reinvested

The present system of taxing capital gains substantively imposes a transfer tax on capital appreciation. As a result, it erodes existing capital available for reinvestment in the capital markets, thereby placing an added burden on the generation of new capital. It also discourages the movement of capital to potentially more productive and higher-risk sectors of the economy. Thus, investments will tend to be locked into mature and financially more secure markets, thereby impeding economic growth.

The present system also taxes as gains the increase in dollar value of assets resulting from inflation. While there is no perfect symmetry between the appreciation in value of an asset and the rate of inflation, a strong correlation is generally present. Under these circumstances, the capital gain tax erodes capital not only by levying a tax on the real gain, but also on the phantom gain from inflation.

The Federal income taxation of capital gains and losses should be modified. To preserve the total stock of capital, gains realized on sales or exchanges of capital assets should be deferred if reinvested in other capital investments. The Federal income tax would be imposed on the gain realized only when capital investments are liquidated and consumed. The deferred gain adjusted for inflation should then be taxed at the applicable ordinary income tax rates with income averaging permitted to avoid the effects of bunching.

The proposal to defer the taxation of the appreciation in value of capital moved to other investments would tend to encourage reinvestment of capital, thereby maintaining high levels of capital investment. The proposal would also, by subjecting any realized true gains withdrawn from investment to Federal income tax at the ordinary income rates, greatly simplify the Internal Revenue Code and provide a more equitable vertically integrated tax structure. But, most importantly, the deferral of taxation of such gains should encourage further the generation of new capital needed by the U.S. economy to enable it to expand, to modernize, and to better compete in the world markets.

Under the proposal, the reinvestment or "rollover" of the proceeds realized on disposition of capital investments must be promptly reinvested to defer the recognition of gain. If losses are realized, they will reduce any gain previously deferred; any gains in excess of such amount will ultimately be realized when the investment is permanently withdrawn from the stock of capital.

Crossover investments (e.g., real estate proceeds reinvested in common stock) should be permitted to maintain flexibility in the allocation of resources. The minimum tax on capital gains and on recapture of certain depreciation could be repealed.

On death, the tax basis of the investment would continue to be carried over in the hands of the successors in interest. This continued rollover is essential since the provision under existing law for a step-up basis tends to create a bias in favor of consumption. When the successor in interest withdraws the funds from the capital markets, he will then be subject to tax on the gain from the liquidation of investments at the appropriate individual progressive tax rates. The Federal gift and estate tax could be retained subject to modification to achieve the indicated tax policy. To the extent these excise taxes remain, they should be modified as already recommended by the administration to reduce the burden on small and/or illiquid estates.

This proposal would apply to all taxpayers, and the progressive tax rates could be adjusted to achieve the desired equitable vertical integration of the tax system reflecting, among other factors, the discouragement of consumption.

Taxation of Real Gains

As has been mentioned a number of times, much of the gain realized on the disposition of various types of investments is really phantom gain resulting from inflation; it does not represent any increase in real wealth, purchasing power, or interests in property. Such gains should not be subject to tax at any rate. Debt securities present special problems in this respect which we have not attempted to deal with in this statement. However, those problems are real and must also be addressed in final legislation.

SUMMARY

We have discussed above a number of proposals which, if implemented, would alleviate the bias against the formation of capital inherent in the present tax system. We recognize that their full implementation cannot occur at one time as the effect on the Federal revenues could be significant. However, if these proposals are phased in over a period of years, the growing cumulative impact in expanding the total economy as well as the tax base will generate significantly greater revenue to help finance the needs of government. If broad general objectives as indicated above are established and used as standards against which future revisions to the tax law are measured, most of the present detriments to capital formation will eventually be eliminated. Over the same period, significant simplification of the tax statutes will occur as distinctions between types of income lose their importance and various other incentives become less important, thus permitting their removal.

April 20, 1976

The Honorable Russell B. Long
Committee on Finance
United States Senate
Washington, D.C. 20510

In oral testimony before the Committee on Finance on March 31, 1976, I made reference to a comprehensive statement on the subject of taxation of foreign income which would be submitted to your Committee at a later date. The statement which follows is the statement to which I referred. We will appreciate inclusion of it in the record of the hearings being presently held by the Committee on Finance.

Our practice is one which serves clients throughout the world. The international scope of our practice enables us to observe the economics of international business. In particular, we have observed the impact of taxes, both foreign and domestic, on international business activities. Our observations have caused us to be greatly concerned about some of the proposals for substantial changes in the U.S. taxation of foreign-source income particularly the elimination or reduction of deferral of taxation on unremitted foreign earnings and further restrictions on the foreign tax credit. Because of our concern, we have prepared the following statement emphasizing the importance of recognizing competitive factors in arriving at policy decisions.

This statement has been prepared solely on the basis of our experiences and observations gained from our professional practice. It was not prepared on behalf of any of our clients nor with their approval or assistance. It is our policy not to appear on behalf of any client or clients.

If you, the members of your Committee, or your staff would like to discuss this statement or question matters relevant to it, we would be pleased to respond at your convenience.

Respectfully submitted,

ARTHUR ANDERSEN & Co.

By

Donald M. Gamet,
Vice Chairman—Tax Practice

U.S. COMPANIES IN INTERNATIONAL MARKETS—THE COMPETITIVE FACTOR IN TAX POLICY *

INTRODUCTION

Congress has had under consideration for several years the question of whether to change the laws with respect to U.S. taxation of the foreign earnings of U.S.-based international companies. The Senate Finance Committee is presently addressing itself to this area.

We believe that the Senate, and Congress as a whole, must, in making their determinations in these policy areas, take into account the extreme competitive problem that exists for U.S.-based multinational companies in international markets. Because of the importance of recognizing competitive factors in arriving at policy decisions, we will direct the emphasis in this statement to that point.

We believe that the relative position of U.S.-based multinational companies in international markets has declined substantially in the past five to ten years. In order to demonstrate that decline, we have accumulated, tabulated, and analyzed pertinent data with respect to U.S.- and foreign-based multinational companies from reliable published sources. The results of our work, which confirms this relative decline, are presented in the section entitled "Competitive Position of U.S. Companies in International Markets" of this statement.

In addition, we will comment upon the effect of proposed changes of U.S. tax laws dealing with foreign-source income upon the competitive position of U.S.-based multinational companies. We believe the adoption of some of the major changes under consideration would place additional tax and financial burdens on U.S.-based multinationals, further damaging the U.S. position in those markets. In this connection, we have attached as Appendix G the Arthur Andersen & Co. submission to the House Ways and Means Committee, *Taxation of International Business by the United States—The Competitive Aspects of Proposed Major Changes in the System*, dated July 15, 1975. That statement sets forth a comparison of taxation of foreign-source income by seven major countries, including those countries which are the primary competitors of the United States in international markets. The tax areas reviewed in the Arthur Andersen & Co. statement deal with taxation of earnings of foreign subsidiaries and branches and with provisions relating to the relief from international double taxation. Our comparison shows that most of the seven countries presently tax international earnings of their national companies substantially more favorably than does the United States. It shows further that in none of these countries do the tax laws provide more restrictive taxation of international business than do the tax laws of the United States. For a summary of the tax provisions of these seven countries, please refer to Appendix F.

The statement goes on to show the potential detrimental effect on U.S.-based companies in international markets if the two changes in U.S. tax laws under consideration are adopted, i.e., (1) taxation of earnings of controlled foreign subsidiaries without regard to repatriation of the earnings and (2) the elimination or substantial modification of the foreign tax credit.

*Appendixes A–G were made part of the official files of the Committee.

We understand and sincerely hope that complete elimination of the foreign tax credit is no longer under serious consideration.

OVERALL CONCLUSIONS

The comparisons and analyses of the accumulated data with respect to the competitive position of U.S.- and foreign-based multinational companies clearly indicate that:

1. The relative position of U.S.-based multinational companies in international markets has declined over the past ten years in relation to foreign-based multinational companies; and
2. That decline has accelerated substantially since 1970.

Our studies show further that, should the United States adopt proposed tax laws that would (1) tax earnings of controlled foreign corporations without regard to repatriation of those earnings and (2) either eliminate or substantially modify the present foreign tax credit provisions of the tax laws, the following will result:

1. U.S. corporations will be required to pay a higher current tax, thereby creating a need to raise additional funds or divert funds from present productive uses. The adoption of a policy that brings this about is inconsistent with the Congressional concern with capital formation. Competitors from other countries will not have the same demand on their capital resources.
2. This demand on U.S. companies will raise the costs and reduce the profitability of those companies in relation to their competitors which are not subject to U.S. or other comparable tax laws. Thus, U.S. companies will be weakened competitively in the world marketplace. This would result in reduced earnings and, thus, reduced market values of company stock, making it more difficult and expensive for U.S.-based companies to raise capital funds. Stock of foreign-based multinational companies would not be similarly affected and would therefore be more attractive to investors, making it easier for the foreign multinational companies to compete for funds in the international capital markets.
3. The assumed tax revenue involved will be collected by foreign governments rather than the U.S. Treasury. In the long run, we question whether little, if any, U.S. revenue will be collected because of the negative impact of the weakening of U.S. international business.
4. Many of the tax incentive allowances presently granted by foreign countries will either be unused or become unavailable, thus eliminating these incentives as an important source of financing for U.S. companies.
5. Since foreign-based companies will be able to more effectively compete with U.S. companies due to their lower working capital needs and financing costs, they will become more successful in international markets as U.S. companies become less successful. Over a period of time, this may well materially shift the balance of

economic power among companies and nations. This may also result in the shift of our technological advantage to foreign competitors, ultimately resulting in U.S. dependence on foreign technology.

6. As U.S. companies lose competitive position abroad, they will become increasingly vulnerable to an equivalent loss of position in the U.S. market also. The strength of international companies from such countries as Germany and Japan will enable them to make important inroads into the U.S. market once they have control of international markets.
7. The management of many U.S. companies faced with the loss of international markets, technology, and possible major inroads into their U.S. markets could not, in fulfilling their fiduciary responsibilities to shareholders, remain inactive. They would have to consider taking actions such as (a) liquidating or disposing of their overseas operations or (b) moving the corporate domicile outside the U.S. taxing jurisdictions.

Because of the factors and conclusions stated above, we strongly urge that no additional tax burdens be placed upon U.S.-based multinational companies, either through provisions for immediate taxation of foreign subsidiary earnings or through substantial changes or modifications of the present foreign tax credit rules. With respect to possible tax abuses in the international area, the present provisions of the U.S. tax laws, as modified by the Tax Reduction Act of 1975, substantially eliminate this as a potential problem.

COMPETITIVE POSITION OF U.S. COMPANIES IN INTERNATIONAL MARKETS

International trade and investment today are highly competitive. Most major businesses are conducted on a global basis. It is apparent that only those companies that can achieve and maintain substantial competitive strength in the international marketplace can survive for a long period of time.

Historically, it has been assumed that U.S. industry dominates world markets. Statistics for recent years indicate that this dominance no longer exists. The relative position of U.S.-based multinational companies has declined significantly. During the past ten years, foreign-based companies, especially those from Europe and Japan, have become increasingly competitive with U.S. companies in international markets.

More important, beginning in the early 1970s, an accelerating trend began: foreign-based companies have been rapidly overtaking and replacing U.S. companies in their relative position as the major commercial forces in the world.

We recognize that there are many factors that enter into this result, including the rapid economic recovery of Japan and European countries from World War II, the varying effects of changing economic factors, such as government fiscal policies, inflation, depression, currency adjustments, etc., as well as important political factors.

We do not pretend to quantify any of these factors, but wish merely to present a picture of what has happened to the relative position of U.S.-based international companies in relation to their foreign-based competitors as that position appears today and as the trend to the current position has occurred over the past five to ten years.

All of the data used in arriving at these conclusions have been taken from statistics published by recognized sources: the Commerce Department; *Fortune;* and the *International Economic Report of the President,* 1973 and 1976.

Share of Worldwide Sales by U.S. Companies

The trend in competitive ability of U.S. companies vis-á-vis foreign companies is apparent from a review of annual sales of the 100 largest firms in the world. The table below shows that, in 1965, 69 U.S. corporations were among the 100 largest companies in the world, ranked by sales. By 1974 (the latest year for which these statistics are available), the number of U.S. companies in the top 100 had dropped to 48.

Distribution of the World's 100 Largest Industrial Companies (Ranked by Sales)

	Number of Companies					
	1965	1970	1971	1972	1973	1974
U.S.-based companies	69	64	58	54	49	48
Foreign-based companies	31	36	42	46	51	52
Total companies	100	100	100	100	100	100

Source: *Fortune,* various issues.
Note: Appendix A provides a summary of the number of companies by country.

If oil companies in the top 100 are excluded, the decrease is from 57 in 1965 to 33 in 1974. This represents a reduction of 22 percentage points (from 66% to 44% of the total number of companies).

Distribution of the Nonpetroleum Companies Among the World's 100 Largest Industrial Corporations (Ranked by Sales)

	Number of Nonpetroleum Companies Among 100 Largest					
	1965	1970	1971	1972	1973	1974
U.S.-based companies	57	49	44	41	35	33
Foreign-based companies	29	32	38	41	45	42
Total nonpetroleum companies	86	81	82	82	80	75

Source: *Fortune,* various issues.
Note: Appendix B provides a summary of the number of companies by country.

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These tables demonstrate graphically that U.S. companies are being displaced by foreign companies as leaders in their industries.

Also during the period 1965-1974, sales of the 50 largest foreign industrial companies increased by approximately $263 billion; sales of the 50 largest U.S. industrial companies also increased about the same amount. However, the annual sales volume of the foreign companies has increased *384%* (from $68.4 billion in 1965 to $331.2 billion in 1974), whereas the corresponding increase for the 50 U.S. companies was only *176%* (from $149.6 billion in 1965 to $412.9 billion in 1974).

Most of these large companies, which compete with U.S.-based companies in world markets, are based in Europe (primarily West Germany) and Japan. The only major foreign country that showed a decline in competitive position was the United Kingdom.

Share of Worldwide Assets of U.S. Companies

The relative growth and related competitive ability of U.S. companies also are indicated by the trends in the relative amounts of total assets of U.S. industrial (nonpetroleum) companies and their foreign competitors. The table below shows the growth in total assets of the ten largest U.S.- and foreign-based companies (ranked by 1974 sales). Since 1965, the combined total assets of the ten largest foreign companies grew by *272%*, whereas the ten largest U.S.-based companies grew by only *117%*.

Comparison of Combined Total Assets of the Ten Largest Foreign- and U.S.-Based Nonpetroleum Industrial Companies (Ranked by 1974 Sales)

	Combined Total Assets					
	1965	1970	1971	1972	1973	1974
			(In Billions)			
Ten largest foreign-based companies—						
Combined total assets	$19.7	$37.8	$46.7	$48.6	$60.0	$73.3
Percentage increase over 1965	—%	92%	137%	147%	205%	272%
Ten largest U.S.-based companies—						
Combined total assets	$45.5	$67.4	$75.8	$81.2	$91.1	$98.7
Percentage increase over 1965	—%	48%	67%	78%	100%	117%

Source: *Fortune*, various issues.

Note: Appendix C provides a breakdown of the names and countries of incorporation of the companies included above.

A similar trend is apparent with respect to commercial banks. The following table shows that the number of U.S.-based commercial banks included in the top 50 banks in the world in 1970 was 15; by 1974, that number was reduced to 11, dropping the U.S. position in the top 50 banks by eight percentage points. Those eight percentage points were picked up largely by banks in Japan and West Germany. (See Appendix D.)

Distribution of the 50 Largest Commercial Banks in the World (Ranked by Assets)

	Number of Banks					Change in Percent of Total
	1970	1971	1972	1973	1974	1970-74
U.S.-based banks	15	13	13	12	11	(8%)
Foreign-based banks	35	37	37	38	39	8
Total banks	50	50	50	50	50	—%

Source: *Fortune*, various issues.
Note: Appendix D provides a summary of the number of banks by country.

Relative Net Income of U.S. Companies

The relative competitive ability of U.S. companies is also indicated by the trend in their net income as compared with that of their foreign competitors. The following table compares the totals of the net income of the 50 largest U.S. and foreign companies for 1965 and for each of the years 1970 through 1974. Net income of the 50 largest foreign companies by 1974 had increased by 263% over the net income in 1965. It can be seen from the table that much of this increase occurred in 1973 and 1974. The corresponding increase for U.S. companies was only 103%. In summary, the table indicates a substantial increase in the relative net income earned by foreign companies vis-á-vis U.S. companies in the last few years.

Comparison of Net Income of 50 Largest U.S. and Foreign Industrial Companies (Ranked by Sales)

	Net Income	
	Foreign Companies	U.S. Companies
	(In Millions)	
1965	$2,651	$11,253
1970	3,974	11,243
197	3,659	12,987
1972	3,692	15,094
1973	8,587	20,761
1974	9,627	22,809
Percentage increase from 1965 to 1974	263%	103%

Source: *Fortune*, various issues. (Details on methods of consolidation of affiliates can be found in specific issues of *Fortune*.)

Share of Gross National Product

The following tabulations indicate that the U.S. share of world production of goods and services has also declined in recent years. Some decline of the U.S. and other developed countries is to be expected in view of the commercial development of the many underdeveloped countries in the world, and such a trend should be considered desirable. However, beginning in the early 1970s, the decline in the U.S. share of world gross national product (GNP) accelerated substantially, and such a decline has not occurred in any other developed country except the United Kingdom.

U.S. Share of GNP

The accompanying table shows the percentage of the world GNP for major segments of the world for selected years during the period 1960 to 1975. The U.S. share of the world GNP in 1960 was approximately 34%; by 1975, it had declined to only 24%.

Percentage Share of World GNP

	1960	1965	1970	1975*
	100%	100%	100%	100%
UNITED STATES	33.7	31.2	30.7	23.8
EEC (excluding U.K.)	12.8	14.2	15.8	17.4
UNITED KINGDOM	4.7	4.5	3.8	3.6
JAPAN	2.6	3.9	6.2	8.8
ALL OTHER	46.2	46.2	43.5	46.4
TRILLION U.S. $	$1.5	$2.2	$3.2	$6.3

* Estimated

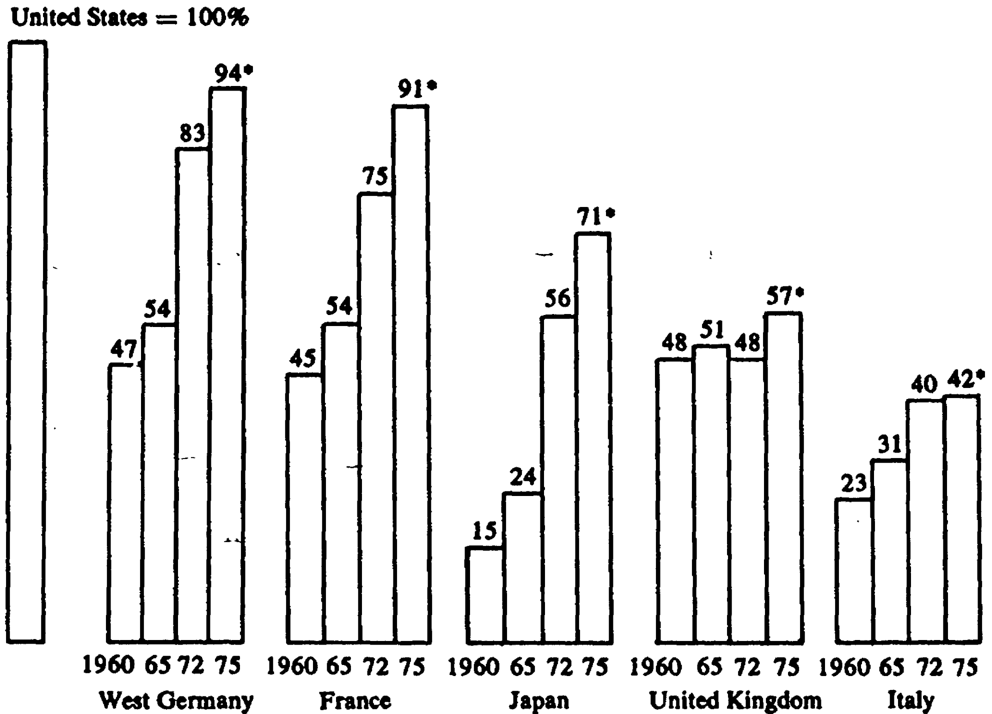
Source: *International Economic Report of the President,* 1976 (based on Commerce Department statistics).

From the foregoing table (and Appendix E which further analyzes relative GNP changes), it is apparent that the 10 percentage point decline in the U.S. share has been taken over by the countries in which our major commercial competitors are domiciled, European Community countries (an increase of more than four percentage points) and Japan (an increase of more than six percentage points). Among the major countries, the only country other than the United States showing a significant decline was the United Kingdom.

U.S. Per Capita Share of GNP

The following table shows the GNP per capita for each of several years during the 1960-1975 period. The countries included are West Germany, France, Japan, the United Kingdom, and Italy. The statistics show that per capita GNP in West Germany and France was less than half that of the United States in 1960 but is only slightly below that of the United States as of 1975. Japan's per capita GNP relative to the United States has grown from 15% to 71%. If these trends continue, GNP per capita in West Germany, France, and Japan will eventually exceed that in the United States.

GNP Per Capita as a Percentage of U.S.



*Estimated

Source: *International Economic Report of the President,* 1973 and 1976 (based on Commerce Department statistics).

The increased shares of GNP of our competitors have apparently been converted to real gains for the residents of their countries. Historically, the GNP per capita of the United States has been substantially greater than that of other countries in the world including developed nations.

Summary of Present Competitive Position

We believe the preceding data, all of which have been extracted from accepted and reliable published sources, show that the relative position of U.S. companies in international markets has declined during the past five to ten years. Since 1970, that decline has been substantial and has been accelerating. The data shows further that the larger companies outside the United States are growing faster than their U.S. counterparts.

Very importantly, it is quite apparent that significant markets exist outside the United States. If U.S. companies are to avoid relative growth stagnation, they must participate in those foreign markets.

ARTHUR ANDERSEN & CO. EXPERIENCES AND CONCLUSIONS

As indicated in earlier testimony, Arthur Andersen & Co. is an international accounting firm which has over 50 offices in 34 countries outside the United States. We have as clients businesses headquartered in most of these countries as well as in the United States. These clients carry on business activities in most of the countries in the world. As a result of our work with these clients and with governments in these countries, we are knowledgeable in the methods and economics of international business and the taxation of such business. Based on this background, we would like to offer comments on our experience with respect to international businesses, as well as our observation on what we believe the effect on U.S.-based multinational companies will be if the major U.S. taxation changes under consideration are passed by Congress.

General Experience—Taxes and International Competition

It has been our experience that decisions to enter into substantial business activities in other countries are not primarily tax-oriented decisions. Taxes are certainly a factor in such decisions as they are in similar decisions within the United States. However, the strong preference among U.S. businesses is to make investments at home and only invest in other countries when available business can only be served through such an investment. It is much easier to serve a market from the United States than it is to get involved deeply with foreign currencies, different legal and tax systems, different labor rules and practices, new sets of government regulations and restrictions, and the many other differences which exist in the economic, social, political, and cultural conditions in other countries. Even the service industries (architects, engineers, bankers, construction companies, etc.), which can only carry on important parts of their work at the work site are normally organized to do as much basic work as possible at home where the pool of experienced talent is located. That basic work is then supplemented and implemented at the site of the project. Many factors are involved in the preference to operate from the United States, a key one being the need to allocate and utilize three very scarce commodities—capital, technical skills, and management talent.

It is clear to us that, when business opportunities exist in countries throughout the world, business entities from some country will take advantage of those opportunities. Thus, if economic factors, government restrictions, or other considerations make it difficult or impossible for U.S. companies to enter into business in a particular country, that opportunity will be taken advantage of by businesses of other countries such as Japan, West Germany, France, and Sweden. Recent worldwide business activity by companies headquartered in other industrial nations, particularly West German and Japanese companies, clearly demonstrates this fact.

Initially, the advantage to foreign competitors from changing U.S. tax law would be relatively lower working capital requirements and financing costs in relation to U.S.-based companies. Foreign-based companies then could be more aggressive in establishing and strengthening operations in other countries and in setting prices in international commerce

generally using the tax differential (and any other competitive advantage) to improve their position. Some U.S. companies would be forced out of a market; others would find that their share of the market would stagnate or drop. Foreign-based companies could be expected to increase their technological and managerial know-how at the expense of U.S.-based companies.

Thus far, the major foreign inroads into U.S. markets have largely been limited to a few industries such as textiles, footwear, and electronics (industries in which U.S. companies have not been traditionally involved in significant investment outside of the United States) and the automobile industry (which does have significant overseas investments). It is also interesting to observe that it is these industries that are faced with the most severe competition from foreign imports. Since more stringent U.S. taxation of industries with important international business would strengthen their already strong competitors in the competitors' worldwide economic activity, that new strength will also eventually be felt in the U.S. markets. The final outcome from this cannot be accurately predicted, but it will not be good from the standpoint of the overall U.S. economy.

Specific Observations—Consequences of Proposed Changes in U.S. Tax Laws

In the paragraphs above, we have briefly summarized our experiences with respect to why multinational companies operate in international markets and, in particular, why it is that basic decisions with respect to those markets are not primarily tax motivated. Taxes, however, must be a factor in such decisions as they are in similar decisions within the United States. These tax factors relate primarily to reduction of costs of doing business, accumulation of funds, and formation of capital in order to become or remain competitive in the foreign markets.

In the remaining paragraphs, we will elaborate further on what we see as some of the other significant consequences both to U.S.-based multinational businesses and to the U.S. economy, if such legislation is passed.

Loss of Foreign Tax Incentives

U.S.-based multinational companies will lose their ability to utilize foreign tax incentives as a source of financing. For example, the United Kingdom provides for a 100% write-off of investments in manufacturing plants in the year of acquisition. Other industrialized countries offer capital cost recoveries in excess of that of the United States. These allowances can reduce substantially the foreign taxes payable by foreign companies in those years. The U.S. tax law allows a credit against U.S. tax for only the actual foreign taxes paid in each year. Thus, if the U.S. tax law is changed to provide current U.S. taxes on controlled foreign subsidiary earnings, the reduced foreign taxes will be substantially replaced by U.S. taxes.

Our general conclusion is that if U.S. tax deferral is ended, the U.S. foreign direct investors would forego the foreign tax incentive allowances and prepay the foreign tax which otherwise could be deferred. This would occur because in later years when the deferred

foreign taxes are paid, the total effective foreign tax rate could exceed the U.S. effective tax rate and, because of U.S. foreign tax credit limitations, a portion of the foreign tax could be lost as a credit against U.S. taxes. This would mean that the U.K. subsidiary of a U.S.-based company could not take advantage of the capital formation funds provided by the U.K. Treasury on the same basis as U.K. competitors not controlled by U.S. investors.

In addition to the tax incentives provided in some of the industrialized countries, many of the less developed countries offer tax incentives to foreign investors in the nature of partial or complete tax exemptions. If current taxation is provided unilaterally by the United States, U.S. companies will have more difficulty operating in these less developed countries because of the U.S. tax burden and will have to forego these market opportunities. Needless to say, this investment area will soon be preempted by foreign competitors.

With respect to less developed countries, it has been suggested that a significant shift of industrial activity will have to be made from the industrial nations to the less developed countries by the year 2000 if these poorer countries are to maintain a minimal economic existence. However, any significant change in U.S. taxation of foreign income may preclude U.S. companies from participating in the new opportunities in the less developed countries.

Competition in Capital Markets

Capital markets, along with trade and direct investment, have also become internationalized in recent years, both in terms of debt financing as well as equity securities. A number of U.S. companies are listed on foreign exchanges and numerous foreign companies are listed on U.S. exchanges. Any tax changes which adversely effect the earnings of U.S. companies relative to their foreign counterparts may also result in their becoming less competitive in raising funds in the international capital markets. Also, U.S. portfolio investors could find equity securities of foreign multinational companies more attractive than equity securities of U.S. multinational companies.

Sale or Decontrol of Foreign Subsidiaries

We have had discussions with a number of companies concerning the possible effects of significant changes in the U.S. taxation of foreign direct investment, and the possible corporate strategies that might be employed. Some of the discussions have centered on abandoning their U.S. corporate citizenship entirely, i.e., moving the domicile of the parent company to a foreign country. Others have discussed the possibilities of decontrolling their interest in existing foreign subsidiaries by selling all or a majority interest to foreign nationals, thereby shifting the control of those companies abroad. An impetus to this shift in control abroad already exists because of the laws of a number of countries, such as the Andean Pact countries.

While not yet widespread, we feel that if any significant changes are made in the U.S. taxation of direct foreign investment solely as a result of U.S. control, more U.S. companies will be reviewing corporate strategies which could lead, at a minimum, to decontrolling their direct foreign investment.

Change in Foreign Taxing Systems

Some of the proponents of current taxation of foreign subsidiary earnings have recognized the impact that such a move would have on the competitive ability of U.S. foreign direct investment. They have generally countered by alleging that other industrialized nations would eventually enact a tax system similar to the one they are proposing for the United States, thereby equalizing the burden of all multinational companies. Based upon our knowledge of trends in corporate taxation outside of the United States, we doubt if this will occur.

However, assuming that all countries ended deferral, we would probably see a polarization of investment. For example, if West Germany ended tax deferral on foreign investment, could a West German automaker manufacture cars in the United States in competition with U.S. automakers when all of the U.S. tax incentives such as accelerated depreciation and the investment tax credit would accrue to the benefit of the West German tax collector? Clearly, the U.S. automaker would have the advantage in the U.S. markets.

Since the United States is the world's largest capital importing nation and since foreign direct investment in the United States has increased appreciably in the last three years, it would appear that, if other nations also ended tax deferral, foreign investment in the United States would significantly decrease.

Restrictions on U.S. Imports

Some people feel that a logical way to limit foreign competition would be to impose high duties, quotas, or other restrictions on imports into the United States. It is clear, however, that protectionist actions on our part would be met by retaliatory actions on the part of other nations. Retaliation could lead to calls for counterretaliation, and the cycle would start again. The end result could be economic disaster for the world.

Relations With Foreign Countries

Applying U.S. taxation to earnings of subsidiaries in foreign countries, particularly less developed countries, may also exacerbate our relations with those countries. They could view current taxation of earnings realized in their countries by national companies operating solely within their national borders as an extraterritorial application of the U.S. tax jurisdiction.

Administrative Burdens

The ending of deferral in one form or another would subject the earnings of thousands of foreign subsidiaries doing business in most countries of the world to immediate U.S. tax. The extra burden which would be placed upon U.S. taxpayers in attempting to comply with a tax system whereby some or all of the earnings of foreign subsidiaries would be subject to current taxation would be enormous. Regardless of the form of current taxation of foreign earnings, U.S. corporations would have to prepare U.S. corporate tax returns using U.S. tax concepts applied to each foreign subsidiary. This would be an exceedingly difficult and

expensive task. In addition, we cannot visualize how the Internal Revenue Service could ever hope to adequately administer the U.S. tax laws in this exceedingly complex area.

The Question of Tax Neutrality

Proponents of legislation to tax all unremitted earnings of foreign subsidiaries of U.S. companies refer to this as ending deferral of tax. Their position is that "equity" among U.S. taxpayers requires that the concept of ability to pay be applied to all sources of income controlled by U.S. taxpayers, regardless of whether the taxpayers' relationship to the United States contributed anything to earning the income or imposed any cost on the U.S. government. U.S. taxation of operations outside of the United States should not be based on such a warped idea of "equity" or "neutrality." There is no logic to imposing current U.S. taxation merely because of U.S. ownership of the business operation involved. Unless the overseas operations in some way directly reduce U.S. taxes, there is no inequity in not taxing the profits which are reinvested in the overseas operations. As indicated earlier, much of the revenue which would be taxed is deliberately not taxed by the host country. The fact that the other government involved is currently less interested in collecting revenue than the United States would be under similar circumstances is no reason for the U.S. investor to lose the resulting benefit.

Summary

In summary, the immediate taxation of all overseas earnings of U.S.-based companies or their subsidiaries would have little or no effect on overall business carried on in other countries; it would merely transfer ownership of such business away from U.S.-based control. This would further accentuate the shift in the balance of economic power away from the United States. This would be a detriment to U.S.-owned business everywhere including that in the United States. Since the tax revenue generated from the proposed changes would flow primarily to foreign governments, the net result to U.S. citizens and their combined interests would be a minimum of benefits at a maximum of cost.

Could any conscientious corporate management faced with such a prospect and charged with the *obligation* of managing their shareholders' investments remain inactive? To do so could subject them to liability for failing to protect corporate assets. It should be noted that shareholders include pension funds, corporate employees, retirees, and many others along with wealthy investors. We have previously described what actions management might take, *none* of which would be beneficial to the U.S. economy or even to the U.S. overall strength in the world. Would it really be in our interest to have our multinationals become companies incorporated in other countries?

We believe a philosophical/political question is involved in this situation, but it is not the one being debated. The real issue is not, "Is the current taxation of unremitted earnings of foreign subsidiaries necessary to achieve 'equity' among the United States taxpayers?" Instead, the issue is, "Is the United States willing to risk driving many U.S.-based companies out of a number of foreign markets and, further, to risk subsequent major foreign inroads into U.S. markets in pursuit of a theoretical and unrealistic concept of equity in taxation?"

Senator CURTIS. We will stand in recess until 10 o'clock tomorrow morning.

[Whereupon, at 12:55 p.m., the committee was recessed, to reconvene at 10 a.m., Thursday, April 1, 1976.]