REVENUE ACT OF 1978

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13511

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954
TO REDUCE INCOME TAXES, AND FOR OTHER PURPOSES

AUGUST 17, 21, 22, 23, 24, 25, AND SEPTEMBER 6, 1978

PART 4 OF 6 PARTS
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REVENUE ACT OF 1978

THURSDAY, AUGUST 24, 1978

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

The committee met, pursuant to recess, at 9:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Byrd, Jr., of Virginia, Nelson, Bentsen, Hansen, Dole, Packwood, Roth, Jr., and Danforth.

The CHAIRMAN. Our first witness this morning will be Reginald H. Jones, chairman of the Board, General Electric Co., and chairman of the Tax Committee, Business Roundtable.

Mr. Jones, we are very happy to have you here with us today. We have had you around here enough times to the point that we feel you are an old friend before this committee.

We certainly will be pleased to have your advice.

STATEMENT OF REGINALD H. JONES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL ELECTRIC CO.

Mr. JONES. Thank you very much, Senator.

I am most pleased to have the opportunity to testify before the distinguished Senate Finance Committee in my capacity as chairman of the Task Force on Taxation of The Business Roundtable.

I would like to start this morning with our views on the deteriorating economic situation. The economic recovery that began in the spring of 1975 is losing its momentum. Real GNP growth declined from 6.6 percent in the first half of 1977 to 4.4 percent in the second half, and has averaged only 3.9 percent so far this year. Moreover, retail sales, adjusted for inflation, have been declining now for the past 3 months and housing starts are weakening due to rising interest rates.

These and other factors have caused most economists to revise their expectations downward, and General Electric's economists now project a significant slowdown in the rate of expansion for 1979 and 1980.

Even assuming a tax cut on the order of $15 to $16 billion, their projections show real GNP rising only 2 percent in 1979 and 1.7 percent in 1980. That compares with an estimated 3.7 percent for the full year 1978. They see unemployment, which has averaged 6 percent during the past 3 months, climbing to 6.7 percent a year from now, and 7.5 percent at the start of 1980. Plant and equipment spending is currently the strongest sector in the economy, but our economists anticipate an average real growth rate of only 2 percent for 1979 and 1980.

Against this backdrop of a fading recovery, we have the Federal Government now in a counterproductive situation. That is to say, unless the Congress enacts prompt and sizable tax reductions effective on January 1, 1979, next year will see about $25 billion in tax increases from inflation and legislation already on the books. That includes increased payroll taxes, escalation by inflation of individuals into higher tax brackets, and higher corporate taxes due to the effects of underdepreciation as well as taxes on phantom inventory profits.

Last March, before the House Ways and Means Committee, The Roundtable urged tax cuts totaling about $25 billion and this level of cuts had broad endorsement in the Congress and the administration. We urged that the tax cuts be effective no later than July 1 of this year in order to keep up the momentum of the economy. Instead, what happened?

The proposed tax cuts have been whittled down and the effective date has slipped to January 1. Meanwhile, the economic outlook has deteriorated and the tax increases already legislated still overhang the economy. In our considered opinion, the situation could slip out of hand unless decisive action is taken to return the target to a tax cut approaching $25 billion, effective no later than January 1.

We share the legitimate concern about the impact of tax cuts on Federal deficits and the resultant inflationary pressures. But an analysis of the current fiscal situation still supports a properly designed tax-reduction program approaching $25 billion.

First, the combined Federal, State and local deficits have declined from $64 billion in 1975 to less than $11 billion estimated for 1978, or from 4.2 percent of GNP to 0.5 percent of GNP.

Second, today's unemployment exceeds 6 percent while the rate of capacity utilization in manufacturing is 84 percent—compared to 91 percent in 1966 and 88 percent in 1973. This suggests that the recent surge in inflation is not caused by an imbalance between supply and demand, but rather is linked to food price increases, cost-push factors such as rising wages, falling productivity and increased cost of raw materials due to import restrictions and the decline of the dollar.

Third, this proposed tax cut would accelerate economic growth in 1979 and 1980 beyond the meager 2 percent which is forecast, thereby helping business to increase volume-related productivity gains which are critical to price restraint.

And fourth, the proposed cuts in corporate taxes would encourage capital spending. This would improve productivity and forestall inflationary shortages and bottlenecks in the early 1980's.

Our full statement, which has been submitted to the committee, spells out our specific tax recommendations in some detail, but let me summarize them quickly.

As to individual tax cuts, the roundtable does not take a position on the specific form of tax cuts for individuals, but there is a broad business support for a significant and balanced reduction of individual income taxes. We thoroughly sympathize with and strongly support the widespread public desire to reduce the oppressive weight of taxation and government spending.

It is just as important, and perhaps more so, to enact significant tax reductions for business and the investors in business. Capital spending is lagging badly, by any measure—past experience, future needs, or comparisons with other countries. Until this country shifts the basic tilt of the tax system to provide a more favorable climate for savings and investment, we are going to face further deterioration of our industrial machine and excessive levels of inflation and unemployment.

Our highest priority recommendation is the permanent reduction of corporate income tax rates. We commend the House for its action in cutting the corporate rate from 48 percent to 46 percent. But in the light of the serious, long-term capital formation problem, we urge a 3-point reduction, to 45 percent, in 1979 and at least 1 point further reduction for each subsequent year until the rate reaches 42 percent.

Small business needs special relief, but instead of scaling the tax rates up in four steps, as proposed in the House bill, we recommend a more simplified system with only one break-point, 17 percent on income up to $75,000 and regular rates (45 percent in 1979) on income above $75,000. This is actually a better break for small business and avoids the disturbing precedent of introducing graduated income taxes for corporations.

Our second priority is to improve the effectiveness of the investment tax credit. We endorse the action of the House in making the 10 percent tax credit. We endorse the action of the House in making the 10 percent ITC permanent, and allowing the credits to offset 90 percent of tax liability instead of the present 50 percent. But the move to 90 percent of liability should be immediate, not phased in, because of the urgent need to stimulate capital investment.

We would also recommend that the ITC be extended to construction of new structures, including all industrial buildings, retail buildings and warehouses, as well as the rehabilitation of existing structures.

The Roundtable continues to oppose the many tax increases, in the guise of "tax reform," that were presented in the administration's original tax bill. It would be especially unwise to repeal or phase out the DISC and deferral provisions at a time when our international trade position is deteriorating and we are running record trade deficits.

And finally, while the current economic climate dictates that we place a higher priority on rate reduction and improvements in the investment tax credit we also fully support both individual and corporate tax relief for capital gains. Because there is a very prompt feedback effect from a cut in the capital gains rate, we believe the capital gains provisions of the House bill, which we endorse, could safely be further liberalized, consistent with revenue considerations—to provide a more favorable climate for capital formation. Liberalization, however, should not remove the safeguards provided to assure that individuals who shelter capital gains will pay a reasonable tax.

Thank you.

The CHAIRMAN. Thank you very much for your statement.

Let me say this to all of the witnesses who will be testifying here today: we have a lot of witnesses to hear today, and we even have an afternoon session to hear some outstanding citizens who will be here to testify.

The way these hearings usually go, we have a good attendance at this time in the morning. By noon, most of the Senators drift out and leave the chairman here, and by 2 o'clock sometimes the chairman is the only one left. So in an effort to move the witnesses through, I am not going to ask any questions of the witnesses this morning, I do not think, unless they just stir me to the point where I cannot sit still in my seat any longer.

I certainly want the other Senators to ask the questions that they think are important for the understanding of the statement.

The CHAIRMAN. Senator, I did not mean to shut you off.

Senator Danforth?

Senator DANFORTH. Mr. Jones, if the corporate rate were reduced to 42 percent, what would that mean to your company and what would it mean to other businesses?

Mr. JONES. I think that it would increase, obviously, the return on investment that American industry has. It is interesting, that in 1965, which was the last year that we had a very major push on new capital improvements and expenditures in American industry, the real return on investment was 9.9 percent. That is after you take out the impact of inflation.

Last year, that return was 4 percent. At 4 percent, you do not have the incentive to take the risks that are involved in major new investment, new greenfield plants, and so on.

A reduction of the rate to 42 percent would be a very significant benefit in terms of that return on investment and would spur capital expenditures.

Senator DANFORTH. You have suggested a phasein of 3 percent in 1979 and 1 percent a year down to 42 percent. A lot of the testimony that we have had has been to the same effect—namely that it is not so much the immediate reduction that is at issue, but a certain knowledge that over a period of time the rate will be reduced to a certain level and that that knowledge, even though the whole measure of the tax cut is not felt immediately, would result in immediate capital investment.

Mr. JONES. Yes, because most major new capital programs are programs that require 3 to 5 years for completion. In the planning phase, when you compute the DCRR (Discounted Cash Rate of Return), you have a barrier level. If the DCRR 5 years out is going to meet this particular criterion that you set, you are going to make the expenditure.

When you make that calculation, you are looking at what the tax rates are likely to be some 5 years out, or 3 years out, so you are quite correct in that statement, Senator.

Senator DANFORTH. You presented this from the standpoint of your company. In The Roundtable, what business wants—how would this affect people? What effect would it have on, say, your employees or the public, if the business rate reduction were enacted?

Mr. JONES. I believe, very frankly, that the American people are beginning to understand the problem of American business because they are not seeing these expenditures made for new plant and new equipment. They do recognize that our productivity has been dropping and as a result, we are not competitive now with our Far Eastern and European competitors. Because this would mean an increase in employment, because it would enhance productivity, I think that they would be supportive.

They are beginning to understand that the only time that they get a real gain in income (and inflation has taught them this) is when productivity goes up. Productivity has actually dropped in the United States during the first half of this year.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Mr. Jones, in your summary, you tread lightly over the subject of deferral of foreign source income, although it was treated at length in your printed statement. I hope we do not face that issue this year; I hope we can just pass over it, based on the studies that were done 2 years ago.

For the record, if, by chance, we were to eliminate deferral or phase it out over 5 years or cut it in half, what would be the effect on trade, on cash inflows to this country from overseas and your business in particular?

Mr. JONES. The effect would be very immediate.

Last year, when the United States ran a $27 billion trade deficit, the General Electric Co. ran a $2 billion trade surplus. That surplus was made possible for the United States as an economic entity because General Electric has made the investment to have affiliates around the world. These affiliates take between a third and a half (depending on the country) of the exports that we ship from the United States.

Without those affiliates abroad, we would not be in a position to install, to engineer, to service the equipment that we sell in these foreign nations.

All of our foreign competitors, particularly in the case of the electrical industry, the Japanese and the Germans, have very strong affiliates in all the LDC's of the world. They are moving increasingly into the United States, I might add; now that their marks and yens are so valuable, they can buy up American industry and compete with us here.

To take away deferral would simply, in our opinion, enrich foreign treasuries at the expense of our own U.S. Treasury. All the analyses that we have made show that if we have to repatriate that income (because we are going to be paying the taxes, and therefore, we have to have the funds with which to make those tax payments), the foreign withholding rates, which are graduated rates in some countries, will mean that the foreign countries get the increased tax revenues. The United States gets little, if anything—probably suffers a loss because the foreign tax credits go up, and therefore, we have a larger reduction in U.S. taxes.

Senator PACKWOOD. Of course, the next move would be to eliminate the deduction of the foreign tax credit.

Mr. JONES. Then, if we are going to do that, we are going to have to give up some 8 million jobs that we have in the United States that are tied directly to the exports.

Unless we become a much more signficant worldwide competitor than we have been, we are in serious trouble.

The United States used to account, 20 years ago, for 28 percent of world commerce in manufacturing goods, excluding exports to the United States. In 10 years, that dropped to 24 percent. Five years later, it dropped to 22 percent. Our share is now less than 20 percent. Last year—we do not have final figures, but I guess it was about 18 percent. That is how serious it has been.

Senator PACKWOOD. Let me ask you one last question. The arguments made on the runaway plants, shipping goods back into the United States, do you ship any significant amount of material, finished goods, back to the United States from overseas plants?

Mr. JONES. The only item of any consequence that we ship back to the United States is radios. We were driven out of the radio business. We were the last domestic manufacturer—this is other than automobile radios—we were the last domestic manufacturer of radios.

Rather than give up the employment of all of our engineering and marketing people, we gradually phased the manufacturing into Hong Kong and Singapore. It was the only alternative that we had.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

Mr. Jones, first let me say that we in Virginia are very proud of the nine, I believe it is, General Electric plants which we have in our State. I think Virginia has been good for General Electric, just as General Electric has been good for Virginia; particularly Virginia has been good for General Electric in the caliber of individual working people that our State has made available.

I know so many of them and have been through most, if not all, of the plants and talked to so many of the employees. You have a wonderful group of employees, I might say.

Mr. JONES. Thank you.

Senator BYRD. I like your statement fundamentally, and agree with most of it.

The Business Roundtable, you are chairman, I believe, of the Tax Committee?

Mr. JONES. Yes.

Senator BYRD. I know many of the members—perhaps most of the members of The Roundtable, and it is, of course, an outstanding group.

But I note in your statement, on page 3, you say, first, the combined, Federal, State and local deficits have declined from $64 billion in 1975 to less than $11 billion estimated for 1978.

But I note in your statement, on page 3, you say, first, the commented on it, at least, except that it seems to me that it ties in with the statement that The Roundtable made earlier this year that President Carter's budget was a lean one.

This statement today seems to deprecate the importance of the Federal deficit. I do not know how The Roundtable can say a budget which, if you take fiscal year 1978, will increase Federal spending by 13 percent over the previous year. The new budget, which The Roundtable calls lean, is 11 percent over and above the 1978 budget.

Now, if the business leaders of this country are going to take the position that the Federal Government is a lean Government when it increases its spending by 11 percent, I think we are going to find it very difficult to do very much about putting the Government's financial house in order controlling inflation.

But I realize that my view is not a majority view in the Congress, and perhaps not even a majority view among the business leaders. I think it is a majority view, however, among the rank and file employees of the General Electric plants, and most other plants throughout our Nation.

I am wondering what your view is on these continued and accelerated and huge Federal deficits.

Mr. JONES. May I comment, Senator?

Senator BYRD. Please.

Mr. JONES. When we made the original statement with respect to the so-called lean budget, as you put it, this was to indicate frankly to the administration that we were pleased with the efforts they had made in terms of cutting their request. They had very substantially cut the requests to get around to that figure, and we had been concerned that we were going to be faced with a budget wll over $500 billion.

Since that time, we have been urging the administration to try to cut further the expenditures that were in that budget, and they have gone some distance on that. I think that more should be done.

We do feel that cutting taxes, and therefore providing less revenues, builds up more back pressure to cut expenditures, and if you do not cut taxes and therefore put that pressure on, you will not get the expenditure reduction that you should get.

The overall figures for calendar year 1978 show a $40 billion Federal deficit, a $30 billion State and local surplus, and thus a $10 billion net deficit compared with $64 billion combined deficit in 1975.

Senator BYRD. Do you not think that the Federal deficit of $40 billion—you are lumping the surplus of the State and local governments in order to reduce the combined deficit is still shockingly high.

Mr. JONES. We applaud all efforts to control that deficit. I was building a total picture of an economy being in the position of needing this $25 billion tax cut.

Senator BYRD. Thank you, sir.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

It certainly is good to see you again, Mr. Jones, and I agree with you that our major concern, I think, is increasing productivity in this country. We started hearings on that about 4 years ago, talking about capital formation.

Mr. JONES. I remember testifying before your committee in April 1974.

Senator BENTSEN. We were early on. It took a while for it to catch on.

We talk about 84-percent productive capacity being utilized in this country. One of the points I think has to be made that that other 16 percent is normally the least efficient in capacity and as we step up, when we get up to the 91 percent we are really dealing with some very inefficient capacity that needs to be modernized.

The equity debt ratio in this country concerns me, and I see companies resorting to a lot of cash tenders for other companies because they can buy undervalued assets, and that is a cheaper way to go than going out and buying new machinery, because they do not have sufficient incentive to accomplish it.

Would you agree with that?

Mr. JONES. Absolutely.

Senator BENTSEN. I notice in your statement you refer to a 5-year amortization election on pollution equipment, add-on equipment. Why would that not be just as reasonable on new OSHA equipment that might be added on where it is Government imposition by regulation adding to the cost, which again makes us less competitve than those nations which are not trying to accomplish what we feel are worthwhile social objectives, but nevertheless puts us in a less competitive positon?

Mr. JONES. You will recall, Senator, that during the war we had so-called certificates of necessity under which, through DPC, we were given 5-year amortization. At the White House Conference on Balanced Growth and Economic Development, we cited this as one mechanism that could be used to solve some of the structural unemployment in these areas, or pockets of high unemployment; that if somebody were willing to take the risk in those areas to put up a new plant, would you be willing to consider a certificate of necessity there for a 5-year amortization?

This more rapid recovery is something that Senator Danforth has been talking about too, as needed to spur investment. It does mean a loss in Federal revenues in the short term. Long term everything comes out even.

So I think that you have a good concept, that we would apply it, not only by pollution control, but OSHA as well, and I would go further and say that it could be used to help solve some other economic and social problems such as structural unemployment.

Senator BENTSEN. We had a group testify before us on the investment tax credit that we ought to limit it—we ought to state that it was for any equipment that would last 3 years. Beyond 3 years, that we not have any recapture on equipment that was not utilized for a period longer than that.

Do you see the judgment on that, or not?

Mr. JONES. No; I do not.

Senator BENTSEN. On the capital gains point, can you see any reason for the runup in the stock market other than the fact that anticipation of capital gains with all of the bad news we have been hearing otherwise?

Mr. JONES. I am a poor person to try to explain the stock market to anyone. I have made about as many bad guesses as most. But I think that the stockmarket has been very undervalued, and there has been a growing recognition of this.

I think that there is a very strong feeling now among individual investors that there is going to be some capital gains tax relief, yes. And I am sure that that has got to be one item that is in the thinking of people who are now moving into the market.

Senator BENTSEN. Would you agree if we have capital gains relief, as I think we need it, that we ought to have an effective date prior to the end of the year, otherwise we are going to have a hiatus where there is going to be a great slowdown in trade or purchases?

Mr. JONES. I think it would be very beneficial if, by the time the bill gets to conference, an effective date could be set, coincident with the day that the decision is made in the conference committee.

Senator BENTSEN. Otherwise, everybody is going to hold until the effective date. If that is next year in the House bill, that is when it will be consummated.

Mr. JONES. That is right.

Senator BENTSEN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. On page 5 of your statement, Mr. Jones, you indicate opposition to the graduated corporate tax schedule as passed by the House. Can you elaborate?

Mr. JONES. I hate to see the concept develop of progressive rates in the corporate tax structure. This is a way of, frankly, introducing an element of inequity that I do not believe we need.

I do believe that it is appropriate to give relief to small business and that the dollars that are provided to small business under the proposal that we have made here—which is the Conable-Schulze proposal that was before the Ways and Means Committee, as you recognize—is one that provides more dollars to small business without introducing this very damaging concept of graduated rates.

Senator DOLE. I do not think that you addressed the subject of indexing, but has that been discussed by the business roundtable?

There is at least a foot in the door on the House side with the so-called Archer amendment. There are some of us who would like to open the door more to index tax brackets, exemptions, and zero brackets.

Has indexing been discussed and studied by the Roundtable?

Mr. JONES. Yes. We have had a number of philosophical discussions of indexing. I must say that we have grave concern that, once you start indexing, you begin to bake in inflationary expectations.

We have a system today where we have some things indexed and some not. The more we go down the route of indexing, the more we find the inequities growing.

If, for example, we go with the Archer amendment and then we decide that we are going to index brackets as they have done in Canada for individual income tax rates, then we begin to see we have not taken care of this situation over here, or that one over there. So before you know it, we build up so many inequities we have to spread this thing a great deal more quickly.

Senator DOLE. Is it not inequity to pay a tax on inflation?

Mr. JONES. It is an inequity, no question about it. I am concerned that it would be very, very difficult to take away from Congress the prerogative of cutting taxes each time a tax bill is considered, and there have been, including this one, seven tax bills that have been passed by Congress in the last 10 years.

So that there is every opportunity to do the indexing, but do it on an ad hoc basis, as you have been doing it. I think taking away from the Congress the ability to cut taxes would be pretty difficult to sell politically.

Senator DOLE. Congress always likes to cut taxes. However, as you indicate in your statement, the bill is not a tax cut. There is not going to be a tax cut if the revenue loss stays in the range of $16 billion. It will not cover inflation and the increased social security costs.

So we are not cutting taxes. Perhaps it is politically attractive because we project an image of cutting taxes.

Mr. JONES. It is politically attractive, and we are recommending that the tax cut be $25 billion to offset the social security tax increases and the impact of inflation on the progressive rate structure, so that you are making the American people whole.

Senator DOLE. If we had indexing there would be more discipline. There would be a need to couple indexing with cuts in spending. Right now, we do not worry about cutting spending. We just pick up $30 to $40 billion by taxing inflation.

I say we do not worry about it. I am certain that there is a great deal of concern about spending, but I just heard on the way in this morning another poll saying that 78 percent of the American people think we ought to cut Federal spending. Some suggest that we cut tax expenditures.

You did not address tax expenditures in your statement. Do you have any recommendations?

Mr. JONES. Yes; very definitely.

To the first point that you have made, if the Congress is seriously going to go to indexing, then I think a very massive study should be made and a very considered action taken that would put indexing in across the system, rather than trying to do it piecemeal because of the inequities.

As to the second, the whole concept of tax expenditures bothers me. It starts with the principle that all income that is earned by the American people and by American corporations belongs to the Federal Government, and only by their largesse may we retain some for the productive plant that we need.

Senator BENTSEN. We have been reading each others speeches.

Mr. JONES. Then, by God, I am on the same horse. I think the idea of putting tax expenditures in the sunset provision would be a grave mistake.

Senator DOLE. There is some discussion of that in the Senate.

Mr. JONES. I understand.

Senator DOLE. Even some disagreement.

The CHAIRMAN. Senator Nelson?

Senator NELSON. I have no questions.

The CHAIRMAN. I am stirred to ask one question of you.

Has it ever occurred to you how big an automatic increase there would be in this country if all so-called tax expenditures automatically expired? It would be about a $180 billion tax increase, and I think business would have to regard that as a sneaky tax increase.

Here is this sunset bill that is supposed to lead to a reduction in Government spending and a reduction in your taxes. Here is a businessman waiting for his tax cut, and then he gets a bill for his share of a $180 billion tax increase.

That is really a sneaky way to slug some poor fellow, and it could be a tax increase where neither a majority of the House or a majority of the Senate were willing to vote for it.

All it would take is one-third in one House plus the President to take away any one of these tax provisions—repeal the DISC, take away the deferral, take away your capital gains, take away just name it on down the list.

Mr. JONES. It is a pretty sneaky approach.

Senator DOLE. There would be a lot of sunsets for a lot of Members of Congress.

Senator HANSEN. Mr. Chairman?

The CHAIRMAN. Senator Hansen?

Senator HANSEN. You responded eariler to Senator Byrd when he commented on the second paragraph on page 3 wherein you seem not to be unduly disturbed over the combined Federal, State, and local deficit because, in your statement, they had declined from $64 billion in 1975 to less than $11 billion estimated for 1978.

I think, as Senator Byrd pointed out, that there has not been very much restraint on the part of the Federal Government. There has been a pretty good track record from a lot of the States, because a number of them have to operate on a balanced budget.

If you want to explain inflation, it can be done very simply. The Government prints too much money. That is all there is to it. You can discuss anything else you want to, but when you get right down to it, our problem today results from the fact that the U.S. Government has been putting out a lot more money than it has had coming in.

Mr. JONES. Because you must monetize the deficit.

Senator HANSEN. On page 6 you talk about capital gains and you say, because there is a very prompt feedback effect from a cut in the capital gains rate, you believe that capital gains provisions in the House bill, which we endorse, could safely be further liberalized.

What do you mean by your statement, "Consistent with revenue considerations"?

Mr. JONES. For 2 months now we have been carefully studying the analyses made by DRI, Chase Econometrics, Merrill Lynch, Martin Feldstein, trying to find some way to quantify the improvements in revenues that would result from the liberalization of the capital gains taxes.

I have got to tell you that I have torn every one of those studies apart and have had sessions with Martin Feldstein and others, and I find it very difficult to reach specific conclusions. But I am convinced, after analyzing the data bases that they use, that there is a very prompt revenue feedback.

When the Budget Committee tells you that you are allowed $19.4 billion if you are going to meet their targets, that is a static consideration. You have to look at the capital gains issue somewhat differently than you look at other tax issues where the feedback is somewhat slower.

I do feel, particularly if you take Senator Bentsen's recommendation that you take a date coincident with the time that you reach a decision, that you would then get some action promptly.

As I have said, we have studied all of these analyses that have been made and decline to make, ourselves, a specific quantitative appraisal, saying if you cut the capital gains rate this much, you will get this result.

But I am convinced, after analyzing all of these, that there is a much faster feedback than there is on normal income tax cuts. The capital gains cut will give you a faster feedback, and faced with the $19.4 billion in the first, and pending, budget resolution for tax cuts, I am saying that is a static approach.

I think you have to take a look at the fact that you will get a faster feedback, and perhaps a dynamic analysis is warranted here.

Senator HANSEN. Now you have gotten to a point that I was hoping you might reach. Most of the testimony that this committee has received, with a few exceptions, has been that cutting the rate on capital gains will not result in decreased Treasury revenues, but rather increased receipts.

There is, of course, no agreement precisely on how much Treasury receipts will increase as you cut capital gains taxes.

Do you agree with that?

Mr. JONES. I do.

Senator HANSEN. Thank you.

Senator PACKWOOD. Could I add one thing there?

The CHAIRMAN. Go ahead.

Senator PACKWOOD. Professor Eisner who testified yesterday, who is opopsed to any cut in capital gains, agreed with that conclusion. He said if you do cut it, it will increase revenue.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. Jones, I am sorry I missed your statement, but I am pleased to see that you say there is broad support for a significant balanced reduction of individual income taxes. I recall that you made a very forthright statement, I think, earlier last year about the need of relieving the fiscal drag, not only from business, but from the economy as a whole.

Secretary Blumenthal, when he was before us, admitted that the possibilities were good that they would be back and proposing further tax cuts next year or other years down the road.

It is my position that it is desirable now to have in place what we are going to do with respect to taxes, both for business and individuals, have it structured first several years ahead of the time.

Let me say why I think this is essential.

No. 1, I think it will bring some discipline into the Government itself, by our making a commitment on the revenue side that we are going to return money to the private economy. This will have a beneficial effect in building confidence both in business and among the people themselves, and it will force Government itself to impose some self-discipline within those budgetary restraints so that, in this sense, we answer the problem that you legitimately raise about the problem with inflation.

I wonder if you would care to comment? Do you think that it is desirable to have a major tax cut phased in over several years from this standpoint?

Mr. JONES. We made the recommendation in our paper on the business taxes that there be a three-point rate cut this first year and at least one-point each succeeding year until the rate reaches 42 percent, so we have accepted your principle.

On the individual tax front, we do not, as the Business Roundtable, comment specifically. We just endorse tax cuts for individuals to offset social security and bracket effect through inflation.

And so, we have refrained from extending the principle that we have used in the business cuts area to the individual cuts. But I see no problem with doing in principle what you are suggesting, because we are recommending that for business itself.

Senator ROTH. No. 2, while I recognize the Roundtable has not taken a position, it is my position that we should have an across-the-board tax cut. In the Roth-Kemp legislation, we do a great deal on the low end of the economic scale, but we also think from the standpoint of promoting saving and investment by individuals, that it is important that tax cuts be extended across the board.

One of the things that concerns me is that what the administration proposes only emphasizes tax relief on the low end of the economic scale. That has more to do with demand and less to do with incentive and supply.

Mr. JONES I would like to comment on that, because, in our paper, we make a very strong point that we have got to stop tilting the tax structure the way we have and to start tilting it until we get increased savings, because without those savings, we cannot have the investment that we need.

Senator ROTH. It is very interesting that the latest Roper poll shows, by 48 to roughly 22 to 24 percent, the American public favors a major tax cut across the board.

Mr. JONES. Yes.

Senator ROTH. The important thing that I think we need to signal by our tax cuts is that this country is moving in a new direction. What bothers me about the administration's proposal is, No. 1, there really is no tax relief. There is a tax increase for most Americans. Second, it does not signal to the private sector that we are moving in new directions.

I think what we should do by our Tax Act this year is to show this is not a temporary aberration, but we really intend to free up the private sector.

Mr. JONES. We would certainly concur with that.

Senator ROTH. Thank you.

Senator BENTSEN. Are there further questions?

Thank you very much, Mr. Jones. We appreciate your testimony.

[The prepared statement of Mr. Jones follows:]

STATEMENT OF REGINALD H. JONES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL ELECTRIC CO.

My name is Reginald H. Jones, and I am Chairman and Chief Executive Officer of the General Electric Company. I'm pleased to have this opportunity to testify before the distinguished Senate Finance Committee.

Today I am testifying in my capacity as Chairman of the Task Force on Taxation of The Business Roundtable. Let me preface my remarks, then by saying that The Roundtable membership consists of 190 business and financial corporations representing a broad range of industries. Different tax proposals have different effects on different industries, and therefore individual members of The Roundtable may not agree with every aspect of the recommendations developed by our Task Force. Nevertheless, these recommendations have had the benefit of wide consultation within the membership, including The Roundtable's Policy Committee; so I believe I testify with the broad support of a significant element of the business community.

TAX CUTS NEEDED NOW

Let me start with our fundamental conviction that there is a need for a significant tax cut for individuals and business no later than January 1, 1979. Otherwise, the U.S. economy could well slip into a recession in 1979.

When I testified on tax legislation before the House Ways and Means Committee last March, I said, "Most economists agree that the United States does not stand at the edge of another recession." Today, I'm not so sure. The number of pessimists is rising, the number of optimists is declining, and most economists are hedging their forecasts very carefully.

During the first half of 1978, economic growth has slackened appreciably. Real GNP growth declined from 6.6 percent in the first half of 1977 and 4.4 percent in the second half of 1977 to 3.9 percent so far this year. Moreover, retail sales, adjusted for inflation, have been declining now for the past three months and housing starts are weakening due to rising interest rates.

Even more important is the shape of the economy in coming months. You have all noted that most economists are revising their expectations downward. General Electric's economists now project a significant slowdown in the rate of expansion for 1979 and 1980. They expect that even with a tax reduction of $15-$16 billion, economic growth will deteriorate as follows:

Real GNP will rise only 2 percent in 1979 and 1.7 percent in 1980—compared with 3.7 percent estimated for the full year 1978.

Unemployment which has averaged 6 percent during the past three months will climb to 6.7 percent a year from now and 7.5 percent at the start of 1980.

Plant and equipment spending is currently the strongest sector in the economy. But our economists anticipate an average real growth rate of only 2 percent for 1979 and 1980.

The reasons for this bearish outlook are not too difficult to fathom: strong inflation and the impact of the tax structure have reduced the growth in spendable real income during the first half of 1978 to an annual rate of only 2.2 percent compared to 4.1 percent in 1977. In other words, inflation and rising taxes have eaten up most of the increase in income which this recovery has produced. This has forced households to incur record debts—a burden which is beginning to dampen consumer spending.

Against this backdrop of a fading recovery, we have the Federal government now in a counterproductive situation. That is to say, unless the Congress enacts prompt and sizeable tax reductions effective on January 1, 1979, next year will see about $25 billion in tax increases from inflation and legislation already on the books. That includes increased payroll taxes, escalation by inflation of individuals into higher tax brackets, and, the higher corporate taxes due to the effects of underdepreciation as well as taxes on phantom inventory profits.

It is essential that these tax increases be considered in the legislation of prompt tax cuts for both individuals and business. Last March, The Roundtable urged tax cuts totalling about $25 billion, and this level of cuts had broad endorsement in the Congress and the Administration. We urged that the tax cuts be effective no later than July 1 of this year in order to keep up the momentum of the economy. Instead, what has happened?

The proposed tax cuts have been whittled down and the effective date has slipped to January 1. Meanwhile, inflation has grown worse, the official forecasts for the economy have declined, and the already-legislated tax increases for next year still overhang the economy. In our opinion, we are losing ground fast and the situation could slip out of hand unless decisive action is taken to return the target to a tax cut approaching $25 billion, effective no later than January 1. Practical considerations probably preclude an earlier effective date such as October 1, 1978, which would be preferable in our judgment.

We share the legitimate concern of the impact of tax cuts on federal deficits and the resultant inflationary pressures. However, an analysis of the current fiscal situation supports a properly designed tax reduction program approaching $25 billion:

First, the combined federal, state and local deficits have declined from $64 billion in 1975 to less than $11 billion estimated for 1978, or from 4.2 percent of GNP to .5 percent of GNP.

Second, today's unemployment exceeds 6 percent while the rate of capacity utilization in manufacturing is 84 percent (compared to 91 percent in 1966 and 88 percent in 1973). This suggests the recent surge in inflation is not caused by an imbalance between supply and demand but rather is linked to food price increases, cost-push factors such as rising wages, falling productivity and increased cost of raw materials due to the decline of the dollar and import restrictions.

Third, this proposed tax cut would accelerate economic growth in 1979 and 1980 beyond the meager 2 percent which is forecast thereby helping business to increase volume-related productivity gains which are critical to price restraint.

Fourth, the proposed cut in corporate taxes would encourage capital spending. This would improve productivity and forestall serious shortages and bottlenecks in the early 1980's when productive capacity may be short of demand and thus trigger demand-pull inflation or a further rise in the U.S. trade deficit.

INDIVIDUAL TAX CUTS

While The Roundtable does not take a position on the specific form of tax cuts for individuals, there is broad business support for a significant and balanced reduction of individual income taxes. We thoroughly sympathize with and strongly support the widespread public desire to reduce the oppressive weight of taxation and government spending. The tilt of the individual tax structure should be adjusted to channel more into saving in the private sector where it will contribute to higher productivity.

Furthermore, we recognize that in these inflationary times the hard-pressed individual taxpayer needs year-by-year reduction of taxes to forestall unlegislated, inflation-induced tax boosts. Only in this way can we restore the flagging vitality of our productive private-enterprise economy and undo the effects of decades of government expansion.

BUSINESS TAX REDUCTION

It is just as important, and perhaps more so, to enact significant tax reductions for business and the investors in business—in order to stimulate investment in job-creating expansion, improved productivity, and indigenous energy sources.

Capital investment by business has been lagging seriously in this period of economic expansion—and that is symptomatic of a long-term problem of capital formation that is slowly gaining recognition in this country.

Real business capital outlays (i.e., adjusted for inflation) are expected to increase only about 5 percent or 6 percent this year, and even less next year. Contrast this with the 10 percent per year increase that the Council of Economic Advisers says is needed over the next several years in order to achieve our national goals in terms of jobs, economic growth, energy and the like.

The reasons for the lag in business spending for plant and equipment are widely known. The real return on investment for nonfinancial corporations, after removing the effects of phantom inventory profits and underdepreciation, has fallen from 9.9 percent after taxes in 1965—a year of strong business investment—to about 4 percent in 1977, and of course much less in the recession years of 1974 and 1975. Faced with such poor returns and a very fresh memory of the recession and the credit crunch that forced many a company to the wall—one can understand why business is hesitant to invest in risky new ventures, new technology, new equipment, or additional capacity.

Undoubtedly, business management would take the risk and boost plant and equipment outlays if it had greater confidence that the investment could be made to pay for itself in a reasonable time. But the future holds many uncertainties, most of them related to government policy: about the cost and availability of energy; about the shape and size of the tax burden; about government-mandated costs arising from environmental and safety regulations; about inflation; about a declining dollar; and about counterproductive government tax proposals that would actually make it harder to compete against foreign multinationals both at home and abroad.

Furthermore, the current lag in business spending is part of a deeper, long-term problem. However you want to measure it—compared with other industrialized countries, compared with previous times in our own country, compared with the estimated capital needs of the coming decade—the United States is not channeling enough of its national output into plant and equipment. As a result, productivity gains have dropped from 2.6 percent a year in the 1960's to 1.3 percent a year in the 1970's, and will be much less than 1 percent in 1978. Real wage gains have been declining, increases in standards of living have been slowing down, and the U.S. has seen its markets successfully invaded at home and abroad by Far Eastern and European competitors.

Until this country shifts the basic tilt of the tax system to provide a more favorable climate for savings and investment, we are going to face a further deterioration of our industrial machine and excessive levels of inflation and unemployment. We cannot expect to turn the situation around overnight, but a start must be made in this year's tax legislation.

BUSINESS ROUNDTABLE PRIORITIES

The Business Roundtable priorities for tax legislation this year are:

1. Reduce the corporate income tax rate.
2. Improve the investment tax credit and make it permanent.
3. Avoid tax increases disguised as "tax reforms."
4. Make a significant start on reducing the taxes on capital gains.

CORPORATE RATE REDUCTIONS

Our highest priority is the permanent reduction of corporate income tax rates.

A general rate reduction has the broadest impact, helping service industries as well as manufacturing businesss of all sizes. It is the most equitable and effective way to lift business spending and encourages the hiring of more people. And being permanent, it gives business managers something they can count on in their investment planning. The effects of permanent rate reduction will be cumulative and self-reinforcing, year after year.

The House Bill is on the right track in cutting the corporate rate by two percentage points, from 48 percent to 46 percent. Last spring, The Roundtable supported the Administration's recommendation for a 3-point reduction in the first year, and a further 1-point reduction in 1980. We still urge that more sizeable reduction, as part of a $25 billion tax bill. If anything, the economic situation calling for tax reduction has become more compelling since last spring. We commend the House for its action but, in the light of more recent economic analyses, and recognizing the significance to increased capital formation of planning ahead with reasonable certainty, the Senate should adopt a program of permanent corporate rate reduction. We urge an additional point (to 45 percent) in 1979 and at least one point more for each subsequent year until the rate reaches 42 percent.

The House Bill also proposes a series of graduated rates for income up to $100,000, as an aid to small business. We agree on the need to grant special relief to hard-pressed small business, but instead of scaling the tax rates up in four steps, we recommend a more simplified system with only one breakpoint: 17 percent on income up to $75,000, and regular rates (45 percent in 1979) on income above $75,000. This is actually a better break for small business and avoids the disturbing precedent of introducing graduated income taxes for corporations.

INVESTMENT TAX CREDIT

Our second priority is to improve the effectiveness of the investment tax credit.

The 10 percent investment tax credit should be made permanent, because underinvestment is a structural not just a cyclical problem and investment is discouraged by the uncertainty of an on-again, off-again tax credit. The House Bill would make the 10 percent investment tax credit permanent.

The House Bill would also permit investment credits to offset up to 90 percent of tax liability instead of the present 50 percent. The bill would phase this improvement in at 10 percentage points a year, but we believe the increase should move to 90 percent immediately, with no phase-in, because of the need to stimulate business spending right now.

The House Bill would limit the credit to rehabilitation of existing structures. However, the investment credit should also be extended to construction of new structures, including all industrial buildings, retail buildings, and warehouses. This would significantly increase employment for the construction industry and its suppliers.

We agree with the House Bill that a full investment credit should be allowed for pollution control facilities subject to the 5-year amortization election; these facilities benefit the public but do not bring in any return on the capital invested.

TAXATION OF FOREIGN SOURCE INCOME

In its original tax recommendations the Administration, under the guise of "tax reforms," proposed tax increases on income of U.S. companies realized from foreign operations—specifically proposals to tax income of foreign subsidiaries before it is received by U.S. parent corporations (popularly referred to as "phasing out deferral") and to phase out the DISC provisions which defer taxes on part of income derived from export business. In testimony before this Committee last week, the Administration, while not asking that DISC be phased out, did propose reconsideration of the present DISC provisions.

The Business Roundtable continues to oppose these proposals since they would be counterproductive, particularly in view of the deteriorating competitive position of the United States in world trade. We are pleased to see that they are not included in the House Bill. It is especially important in this year, when the United States is again running a huge trade deficit for the second year in a row, that Congress refrain from penalizing off-shore business activities.

In 1976, Congress reviewed in depth both deferral and DISC. As a result of this examination, the Congress decided to preserve both provisions of the tax code, though DISC was revised to relate tax benefits to export improvements and to meet other criteria of the Congress.

Moreover, a House Ways and Means Committee Task Force examined the deferral question in 1976 and announced in 1977 that it had decided not to make any recommendaations to change the law with respect to deferral.

These decisions were made because it was recognized that phasing out deferral and DISC would reduce exports and jobs in the United States. If this made good sense two years ago, when the United States had just registered an export surplus of $9 billion, it makes even better sense now. Our trade deficit was $27 billion in 1977, and in 1978 it will be much worse.

Exports of U.S. products provide at least eight million jobs in the United States. About 25 percent to 30 percent of these exports are accounted for by foreign affiliates of U.S. companies. Thus, the ability of foreign affiliates to compete abroad on equal terms with foreign based, foreign controlled multinational companies in an ever increasingly competitive climate is crucial to the maintenance of our export position.

A change in law to tax the earnings of those U.S. foreign affiliates before being received in the U.S. (anticipatory taxation) would impair the ability of U.S. companies to reinvest their overseas earnings to strengthen their competitive position. As concluded in a recent study by Arthur Andersen & Co., the added tax burden would be substantially greater than Treasury estimates, with foreign governments rather than the U.S. being the beneficiaries of this increased burden.

With respect to DISC, it is virtually impossible to agree on how much it has contributed to increased exports. One thing, however, is certain: it is in place and it is the only offset we have—and a partial offset at that—to tax rebates or waivers of taxes through which other governments help their export industries.

Although economists may not recognize it from their national statistics, businessmen know that DISC funds provide additional working capital which is so essential to the financing of long-term receivables required in competition for exports. DISC also provides funds for market development work required to expand exports and related jobs.

We should never lose sight of the fact that our foreign-based competitors will continue to enjoy the benefits from tax deferral and export incentives of their home governments. The proposed changes in U.S. tax law affecting international trade will penalize only American-owned firms; they will not affect the overseas operations of our foreign competitors.

It is essential to view deferral and DISC not in terms of tax politics or possible short-term gains in tax revenues, but in terms of our economic and national security interests in the world.

As your Committee hears conflicting reports about the value of these two tax provisions, you may wonder who is a credible authority. Economists inside and outside the government have come down on both sides of the question. Perhaps the experience of businessmen who are actually engaged in international competition may be more telling.

For example, in 1977, while the United States was running a $27 billion trade deficit, the General Electric Company achieved a trade surplus of more than $2 billion. Our experience strongly indicates that rising exports, in stiff competition with foreign multinationals, are the result of two strategies:

Willingness to invest heavily in foreign distribution—research and planning, service facilities, costly proposition work—long before it yields results. DISC funds are critical in supporting these high-risk activities.

Successful foreign subsidiaries which are pulling through more than 37 percent of GE's exports. Tax deferral which enables off-shore manufacturing subsidiaries to compete on equal terms abroad with foreign competitors is a critical force in boosting our exports.

So the deferral and DISC issues should be seen in the context of our balance of payments problems, and our need for exports and jobs. Phasing out these two provisions of the tax code would be most untimely and contrary to the national interest. Instead, the government should be developing an affirmative policy to encourage U.S. exports, defend the dollar, and make U.S. industry more competitive in the battle for world markets.

CAPITAL GAINS TAXATION

Taxation of capital gains merits the attention it is being given this year. Although some countries do not tax capital gains at all, the Tax Reform Acts of 1969 and 1976 sharply increased taxes on capital gains in the United States with a significant dampening effect on savings, investment, and the raising of new venture capital.

Since extensive testimony on capital gains tax cuts has been presented at earlier hearings, I shall be very brief on this extremely important matter.

Ever since The Business Roundtable began making tax recommendations, it has advocated reduction of the taxes on capital gains. Although the current economic climate dictates that we place a higher priority on rate reduction and improvements in the investment tax credit, we also fully support both individual and corporate tax relief for capital gains to encourage greater capital mobility and to contribute to increased capital formation.

As you know, the several proposals that have been made on capital gains have invoked intense controversy. The House Bill, a compromise hammered out in the furnace of our political processes, represents a feasible and constructive approach to capital gains taxation, and we endorse it. By reducing the maximum capital gains rate for individuals to 35%. The House Bill makes a significant start in the right direction and at the right time.

There have been many studies of the feedback effects from lower capital gains rates, producing a wide range of results. After a careful reading of these studies we are convinced that, while it is impossible definitely to quantify these effects, there undoubtedly is a very prompt feedback. We, therefore, believe that the provisions of the House Bill related to taxation of capital gains could safely be further liberalized, consistent with revenue considerations, to provide an even more favorable climate for capital formation and for a return of investors to the nation's securities markets. Liberalization, however, should not remove the safeguards provided to assure that individuals who shelter capital gains will pay a reasonable tax.

The CHAIRMAN. Our next witness is Mr. Robert M. Brandon, director, Tax Reform Research Group.

Mr. Brandon, please come forward and if you would introduce your associates for the record.

Mr. BRANDON. Thank you, Senator Bentsen.

My name is Robert Brandon. I am director of Public Citizen's Tax Reform Research Group. With me is the staff attorney, Robert McIntyre.

We have a full statement which we would like to include in the record, and I would just like to summarize.

STATEMENT OF ROBERT M. BRANDON, DIRECTOR, PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP, ACCOMPANIED BY ROBERT S. McINTYRE, STAFF ATTORNEY

Mr. BRANDON. I would like to focus first on the need for the tax cut. If you take a look at our testimony on page 2, because of inflation and social security hikes the effective tax rate, as you can see in the first table there, will actually increase about 1.3 percent.

The problem we see is that the tax cuts that have been passed by the House and advocated in some corners in the Senate will not take care of the major impact of inflation and payroll taxes on a majority of middle income and lower income taxpayers.

If you take a look at the last column in the first table, you will see that the tax increases fall most heavily on taxpayers with incomes below $50,000.

But the House bill actually fully protects from inflation and payroll tax hikes only those taxpayers in the $50,000-and-over category.

The only group that really gets a tax reduction are people who make over $100,000 per year. We feel that there has to be a dramatic shift in the tax reductions to protect lower and moderate income taxpayers. We think a fair tax cut could be designed along the lines of the Fisher-Corman proposal in the House or along the lines of the AFL-CIO program suggested to this committee.

I would like to move on to the capital gains proposals that have been floating around. We strongly oppose any effort to further increase capital gains tax preferences.

We note that, already, capital gains are being taxed at very low rates. In fact, capital gains tax preferences total some $17 billion, and Treasury collects only a third the taxes it would collect if capital gains were treated like other income. In addition to the general problem with cutting capital gains taxes at all, we would like to focus on specific problems with members of this committee and others in the Senate and House.

I would agree with Mr. Jones of the Business Roundtable that corporate tax cuts are a much better stimulus to the economy. In fact, when we talk about cutting capital gains rates, I think that it is difficult to see how there would be a great deal of investment stimulus when three-quarters of that capital gains reduction would go to non-stock-market-related investment, primarily in real estate speculation, farmland speculation and the like—not very productive investment.

So that the main point, we think, is that capital gains reductions do not provide the economic stimulus, the bang for the buck, that has been touted. Secondly, there is a great deal of misinformation being circulated about capital gains.

It has been proposed that the capital gains tax rates be cut from nearly 50 percent to 25 percent. But nobody in this country pays 50 percent on capital gains on their Federal income tax. No one pays the top theoretical rate of 49 percent. Only a miniscule percentage of capital gains recipients pay over 40 percent.

If you eliminated the maximum tax you could reduce the top possible rate to 39 percent, at a very small revenue loss—nothing approaching the $2½ billion that, for example, the Hansen-Steiger bill would cost.

The attempts to reduce the top rate focus, however, primarily on eliminating the minimum tax on otherwise untaxed capital gains, the minimum tax which we consider a cornerstone of the fairness of our tax system.

For example, under the Hansen-Steiger bill, 3,000 people earning over $1 million a year would get tax reductions averaging $214,000 apiece. Those 3,000 people would actually get 40 percent of the Hansen-Steiger capital gains tax reductions.

Average reductions would be about $60,000 apiece for 20,000 or so individuals earning over $200,000 a year. Of course, no benefit at all would go to 99.6 percent of all taxpayers, and about 93 percent of taxpayers with capital gains would receive no benefit by eliminating the minimum tax.

The House bill does not do much better, because it also repeals the minimum tax substantially and there, again, only 0.4 percent of the taxpayers get relief and only about 6 percent of the people with capital gains get relief.

Three-quarters of all of the benefits from H.R. 13511 will go to people making over $100,000 a year. The House replaced the minimum tax that it repealed on capital gains with a very small—what we would consider insignificant—micro-mini tax on capital gains.

Just for example, the typical high-income, nearly nontaxpayer, somebody who has total income—I have an example on page 11 of our testimony—total income of about $600,000 a year, pays right now about 7 percent of his or her expanded income—79 percent of that comes from the minimum tax.

If the House-passed minimum tax was passed the effective rate could drop to 4.1 percent.

We think it is important, if anything is done in the capital gains area, that a strong alternative minimum tax be adopted to make sure that individuals cannot shelter substantial amounts of their otherwise taxable income. Capital gains are a key factor in these nontaxpaying situations.

In fact, for people over $200,000 a year who paid no income tax at all last year, 99 percent of their income was from capital gains, and for taxpayers in that same income class who were able to shelter more than 80 percent of their income, capital gains comprised over 60 percent of their income.

We would also strongly argue that inflation adjustments are unwise. Particularly, targetting capital gains alone and not providing indexing for any other income would be unfair. It amounts to a $3.3 billion tax cut for capital gains, which is totally unwarranted.

If we look down the road of indexing the entire system, I think that there should be a great deal of concern that we would move toward building in inflation into the economy, and I think it would be a bad experience.

We also already have an inflation adjustment for capital gains by simply taxing only one-half of the gain, and we think that is more than adequate. In fact, we would like to move in the other direction.

Let me say there is concern about investment stimulus and locked-in capital assets. One of the best ways to unlock those capital assets is to let the carryover basis on capital gains become law or even better, to pass a capital gains at death proposal.

I would like to focus briefly on reforms, although I do not think many people here on this committee really want to ofcus on them. Congress is apparently not in the mood to fulfill its promise—when the Members go home to run in each election—to the American people in terms of reforms and eliminating some of the unfair and wasteful tax preferences that we have.

Substantial numbers of the American taxpayers support reforms in the area of expense account living, eliminating DISC and other kinds of elimination of tax preferences.

I would like instead of taking the time now to go through those reforms, to submit for the record a copy of our House testimony on the President's tax reform proposals.

Senator BENTSEN. Without objection, it will appear in the record.

[The material referred to follows:]

STATEMENT OF ROBERT M. BRANDON, FOR PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP

Mr. Chairman and members of the Committee, my name is Robert M. Brandon. I am Director of Public Citizen's Tax Reform Research Group—an organization established by Ralph Nader in 1972 to work for reform of our tax laws. We welcome the opportunity to testify today on the President's 1978 tax program.

SUMMARY OF OUR POSITION

We wholeheartedly endorse all of the revenue-raising reform measures in the President's program and the conversion of the $750 personal exemption and the general tax credit into a single personal credit. The proposals represent a major step toward restoring fairness and simplicity to our tax laws.

To be sure, the program is not as comprehensive as the President originally promised, and the Committee may wish to augment it. For example, the minimum tax could easily be strengthened by applying it to additional preferences and raising the token 15-percent rate. Also, mandating that taxes be withheld on interest and dividends (above some reasonable threshold amount designed to exclude small recipients) would boost federal revenue collections by well over a billion dollars and curb outright tax fraud.

We strongly oppose the business tax cuts. The way to encourage investment and meaningfully to assist business in meeting its capital needs is to curb inflation and cut the budget deficit.

Every time individual taxes are cut to allow for inflation pushing people into higher brackets, business comes along asking for a handout—although their flat tax rates are unaffected by inflation. Repeating the pattern of recent years, the Carter plan accompanies its "stay even" individual cuts with a huge, real reduction for corporations. It's time this practice was stopped.

Thanks in part to this practice, the percentage of federal revenues raised by the corporate tax has dropped from 30 percent in 1954 to 21 percent in 1964 and to 15 percent in 1977. Simultaneously, the average effective rate of tax on corporate income has steadily declined until it is presently only about 25 percent. By contrast, the percentage of federal revenues raised through social security payroll taxes has increased from 10 percent in 1954 to 30 percent in 1977.

It is especially important that the Committee reduce the corporate tax cut dollar for dollar to the extent it fails to enact any portion of the business reforms, such as repeal of DISC, deferral, and deductions for business lunches.

In the individual area, the President's program hits some of the worst "tax shelter" abuses in the tax system. It also takes important and laudable steps toward simplifying the tax laws and making them fairer for average taxpayers by cutting back on itemized deductions. If the Carter package is enacted, the number of itemizers will drop by 40 percent. The Committee may be tempted to take a different approach than the administration has on the treatment of medical expense deductions—perhaps considering a lower percentage floor. Strictly from the point of view of fairness, the proper level for the floor is certainly debatable. But the Committee should also keep in mind that a lower floor will mean substantially less simplification. It will also mean less revenues available for general rate cuts.

The Committee should also keep simplification goals in mind if it considers adding new individual tax expenditures—like tuition tax credits—to the tax code. Last year's Tax Simplification Act began a desirable trend toward making the tax system comprehensible to average taxpayers, and it would be a terrible shame to see that trend reversed.

Although the targets of the President's corporate tax reform proposals are some of the very worst, most unfair, and harmful loopholes in the tax system, and although the President accompanies his repeals with a huge corporate tax reduction, the few who benefit from these tax boondoggles are waging an all out battle to retain them. The President has put the issue in stark terms: Unless these reforms are enacted, we cannot afford the full tax cuts he is requesting. This Committee and the Congress should recognize that average taxpayers would perfer having the money in their own pockets, rather than having it spent for them on export subsidies for General Electric, tax breaks for multinationals, and expense account living for executives.

EXPENSE ACCOUNT LIVING

The problem: Executives entertain themselves and receive personal enjoyment at the expense of average taxpayers

Under current law, businesses are allowed a tax deduction for virtually any expenditure which is at all helpful or related to making a profit, including meals and entertainment expenses for employees and customers. Those personally benefitting from the meals, shows, and so forth do not have to include these benefits in income. But those of us who pay for our own entertainment do so out of wages that are already taxed. The result is that a favored group of Americans—mainly high income executives and business owners—are enjoying football tickets, vacations, and "three martini lunches" out of tax-free money. In other words, a lot of lavish living is being subsidized by average taxpayers.

The nation is fast becoming familiar with the Treasury Department's example of the notorious New York businessman who successfully billed the taxpayers for 338 $20-plus business lunches in one year—skipping Thanksgiving, but not the Friday, Saturday, and Sunday thereafter; the enterprising electrical fixture salesman who wrote off breakfast, lunch, and dinner five days a week, to the tune of $8,000 in one year; and the sea-going surgeon who deducted $14,000 for "consultations" with his friends aboard his yacht.

Pepsico and Owens-Illinois jointly lease a salmon stream in Iceland for their top executives' enjoyment, and Marc & Co., a Pittsburg advertising firm, provides its top officials with a "very simple but pleasant" villa on Spain's east coast.

Playboy Enterprises deducts $2.8 million per year for the maintenance of its two mansions—complete with elaborate pools, artificial grotto, exotic flora and fauna, and other pretty things—for the pleasure of Hugh Hefner and his invited guests.

And these "horror" stories are only the tip of the iceberg—perhaps not typical, but surely representative of what goes on. A national survey of 468 companies by Hays & Associates, a Philadelphia management consulting firm, showed that top executives making $100,000 salaries average about $30,000 per year in expense account benefits! If that $30,000 were salary, they would have to pay taxes on it (just as the rest of us have to pay taxes before we can entertain ourselves).

Average taxpayers often wonder how all this can go on. The answer is that Congress has authorized it in the tax code. Prentice-Hall publishes primers telling executives how to structure their personal lives to shift their entertainment bills to the taxpayers. Some samples from one:

BIG T&E WRITEOFF

How club members get top-dollar deductions—year in and year out

Club memberships can mean big deductions. It makes no difference whether they're country clubs, athletic clubs, or fishing and hunting clubs. They are all good for business—either to have a customer to dinner, to golf with a group of execs, or for an outing sponsored by a local businessmen's organization.

Meals and bar bills: Suppose you take your top-level execs to dinner at your club—or you have a few drinks with them at the club bar. *Deductible?* Yes. You can write off every single penny. And you can deduct it whether or not you and your guests discuss business matters.

Added Bonus.—A day when you're using the club for business reasons counts as a business day even if the family's using it for pleasure at the same time.

So you can get extra personal use out of the club without jeopardizing your entertainment deduction.

Key tax-saving move: Make a point of having a quiet business lunch (or breakfast for that matter) with your customers on the same day you play golf with them. *Another point:* A few drinks with your customers at the club bar can also transform a casual golf date into a full-fledged business day. One qualification: The bar must be quiet and have "no substantial distractions to discussion."

If you and a customer have a quiet lunch or dinner at the club, you get this—

Triple benefit.—(1) The cost of the meal is deductible in and of itself. It also helps nail down and *increase* your club dues deduction, counting as (2) a *business day* that helps bring your business use of the club over the 50 percent mark, and as (3) a *directly related expense* that adds to the amount of your dues deduction.

Deduction saver: As you get down to the end of the year, you may find your personal-use days running neck and neck with your business-related days. When this happens, here's—

What to do.—Schedule some quiet business meals at the club. They can make the big difference that wins you the deduction.

Idea in action.—If you belong to more than one club—and many do—you may want to use one club strictly for business entertaining, and the other for socializing.

The Executives Tax Report brings you ideas for reducing taxes and increasing wealth

In addition to allowing these tax-free benefits, expense account living perverts business decisions, with many sales being based more on the quality of entertainment than on the quality of the product. This was graphically illustrated a few years ago when the Northrop hunting lodges for the Pentagon top brass—Northrop's major customers—were exposed. The result is that average Americans not only subsidize executive high living, but also suffer from lower quality, unsafe products in many cases due to the system of petty bribery which the entertainment deductions encourage.

Administration proposal: Cut back on the unfair deductions

During the campaign, the President came down hard against three martini lunches and other business deductions for personal expenses. In doing so, he echoed the words of John F. Kennedy, who 16 years ago called "for the slogan 'it's deductible' to vanish from the land."

Compared to this campaign rhetoric, the Administration's proposal on meals is rather mild. Business lunch deductions would not be eliminated, but in general only halved. In other words, the $20 business lunch, which currently costs business about $10 if they're in the 50 percent bracket (because the government picks up half the tab), would cost about $15. And when an executive is away from home overnight or longer on "travel status," meals would continue to be *fully* deductible.

Other abuses, however, would be dealt with more stringently, with deductions for football tickets, hunting lodges, country club fees, and the like totally disallowed. Businessmen who fly first class could only deduct the cost of coach. Executives, doctors, and lawyers who attend "conventions" and "professional seminars" in exotic vacation spots around the world would no longer be able to do so at taxpayers' expense. Presently, two such foreign "conventions" can be written off every year—no questions asked, leading to abuses like the following solicitation by the California Trial Lawyers Association:

DEAR COLLEAGUE: Here it is . . . An entirely new concept in professional group travel/study programs. Look over the trips described in this booklet . . . to exciting destinations all over the world. Decide where you would like to go this year: Rome. The Alps. The Holy Land. Paris and London. The Orient. Cruise the Rhine River or the Mediterranean. Visit the islands in the Caribbean. Delight in the art treasures of Florence. An additional benefit is that these travel/seminar programs haave been designed to qualify under the 1976 Tax Reform Act as deductible foreign seminars. Let's all share together these splendid travel opportunities.

The President would allow tax write-offs for foreign conventions only if there is a legitimate business rationale for holding them outside the country. This would curtail the vacation abuses whereby a totally local organization holds its "conference" in Athens or Jamaica in order to give its members a tax deductible junket, but would allow companies or organizations whose operations or members are abroad to hold their meetings at convenient places without adverse consequences.

Three Martini lunches: The bogus "jobs" issue

Tax deductions for theatre tickets and yachts are particularly scandalous, but the deduction for business meals is almost equally indefensible, since—perhaps more than anything else—everybody has to eat. Opting to eliminate only half the meals deduction is basically a political decision to try to assuage the restaurant lobby. It is argued by restaurateurs that taking away deductibility would cost many jobs and cause many fine restaurants to close. The jobs argument is specious.

The Treasury Department estimates that if every penny in lost tax benefits due to the denial of half the meal deduction resulted in reduced spending in restaurants, the restaurant industry would experience a 1.3 percent reduction in jobs. This "maximum effect" is, of course, very unlikely, since, deductible or only half deductible, eating would still continue. Even if less *is* spent on meals, the money saved will be spent elsewhere, creating jobs in other industries. In fact, the increased corporate and individual tax cuts for all of us which curtailing part of the meals deduction makes possible is estimated to create the same number of jobs as the maximum which the restaurant industry might lose. Thus, even in the worst case, the net effect on jobs is negligible. And because of the high turnover in restaurant employment already (far above 1.3 percent), any lost employment would probably not be reflected in layoffs but in decreased new hiring. In the far more likely event that the effect on restaurant business is even less, the curtailment of the meals deductions in conjunction with the consequent tax cuts could actually create numerous new jobs, as presently unemployed people would be hired in other industries. In fact, the AFL–CIO, which represents workers in a broad range of industries—including restaurants, has come out in strong support of the President's proposal.

The restauateurs are making wild claims that 500,000 jobs will be lost if meal deductions are cut in half. To reach this figure, they assume that *all* business spending on lunches will cease and that executives will thereupon stop eating. Of course, nobody believes *either* of these assumptions—a *Wall Street Journal* informal survey of executives, for example, found that the change in the deduction rules would have virtually *no* effect on business practices—and nobody should believe the job estimates either. Last year, some restaurant owners similarly predicted that a boost in the minimum wage would result in a disastrous number of laayoffs. But on Feb. 19, 1978, the *New York Times* reported: "A sharp increase in the minimum wage has gone into effect, apparently without producing the predicted cutbacks in the number of low-paying jobs." The article noted that "the number of teenagers at work has jumped enormously despite the pay increase." It quoted a restaurant manager as saying, "We're not in a position to cut employees. We don't anticipate any real change [in the future] either." As a recent Library of Congress report found, the restaurant industry will continue to expand faster than practically anything else in the country, in spite of a cutback in business lunch write-offs.

Cutting back on lunch deductions might exert a little downward pressure on inflated meal prices; now many business men don't care how much things cost when "Uncle Sam is picking up the tab." It is quite unlikely, however, that restaurants would be forced to close. Perhaps those whose only attraction is proximity to business districts might have to make some adjustments, but those with genuinely good food ought to bear up well. At most, they will lower their prices a bit, making good food more accessible to those of us not living on expense accounts. And moderate-priced restaurants should prosper under the proposal; one way or another, everybody will still have to eat.

The entertainment tax boondoggle must be curtailed

Overall, the Carter proposals on entertainment constitute a needed step toward lifting the burden of subsidizing executive entertainment from the shoulders of average taxpayers. Perhaps more than anything else, expense account living symbolizes the unfairness in our tax system. Failure by Congress to act in this area would mean that our representatives have sanctioned these inequities. An illustration of how this can breed popular disrespect for the tax laws is contained in the appendix.

DISC AND DEFERRAL

The problem: Some of our biggest corporations have two special boondoggles—and we pay in higher taxes and lost jobs

Currently, American taxpayers pay $1 billion a year for special tax subsidies to a few thousand firms engaged in export activities. Two-thirds of these so-called "DISC" benefits go to companies with assets of more than $250 million—the top 0.1 percent of U.S. businesses.

Every year giant U.S. multinationals are excused from paying hundreds of millions of dollars in U.S. taxes on their foreign profits. Totalling some $600 million in 1977, the condition for this "deferral" (translation: permanent forgiveness) is that the tax savings, along with the profits they are associated with, be reinvested overseas.

General Electric has earned the title "DISC, Inc." for its ardent lobbying in support of the export tax break. One reason for G.E.'s enthusiasm: It picks up an estimated $50 million of the total benefits of DISC and deferral on its own.

Deferral: A subsidy for exporting capital and jobs abroad

Since the beginning of our income tax system, U.S. corporations operating through overseas subsidiaries have been allowed to put off paying U.S. taxes on their foreign income until the earnings are brought home. So long as the profits and tax savings are reinvested in foreign countries, this "deferral" amounts to a permanent forgiveness of U.S. taxes. Due to this undertaxation of our multinational giants, average Americans have to pay higher taxes. Even worse, the "deferral" privilege is an incentive for firms to invest abroad rather than in the U.S., thereby "exporting" needed capital and jobs which would otherwise be created here. Partly as a result of this tax break, U.S. business has invested over $160 billion of job creating capital abroad in the past decade. A study prepared for the State Department showed that the U.S. would have had one million more jobs if U.S. corporations had attempted to serve foreign markets from a U.S. base.

Deferral also leads to a great deal of complexity in the Internal Revenue Code and creates impossible problems in enforcing the tax laws. Multinational companies take advantage of this to juggle their books to shift income between high and low tax countries and to increase their "foreign tax credits" to artificially high levels. Many believe that deferral contributes to large-scale illegal tax evasion.

Who benefits from deferral? The largest, fastest-growing, most profitable, and most sophisticated corporations in the country. Between 80 and 90 percent of the multinational subsidiaries involved are controlled by Fortune 500 corporations. IBM, Kodak, Polaroid, and Dupont head the list. In fact, a recent Treasury study shows that the largest 30 U.S. multinationals—all with assets of more than $250 million—picked up half the benefits of deferral on their own.

DISC: Compounding the mistake of deferral

In the early 60's President Kennedy proposed to repeal deferral, but under intense lobbying pressure from the multinationals Congress refused. Instead, in 1971 Congress accepted President Nixon's recommendation to extend the benefits of deferral. In order to give U.S. companies exporting their products overseas a tax advantage similar to that enjoyed by their competitors producing through foreign subsidiaries, Congress established Domestic International Sales Corporations (DISCs). Under the complicated DISC provisions, exporting corporations were authorized to set up artificial, "paper" subsidiaries (called "domestic international sales corporations"), and to "defer" indefinitely half the taxes on their profits from foreign sales.

From the beginning DISC has been an unjustified windfall to export firms at the expense of average taxpayers. It simply pays a small number of companies to do what they would do anyway—export overseas. Soon after the enactment of DISC, the chronically overvalued U.S. dollar was devalued and then allowed to float. This, coupled with inflation and a general expansion in world trade, caused a dramatic surge in U.S. exports, and the DISC tax break tagged along. The cost of DISC zoomed to $1.4 billion per year, as firms enjoying increased foreign sales also took advantage of the 50 percent tax subsidy.

The 1976 Tax Reform Act: An inadequate response

In the 1976 Tax Reform Act, Congress reduced the DISC tax exemption to about one-third of export profits (rather than 50 percent). This compromise change included a complicated attempt to "target" DISC's benefits to companies which are actually exporting more in response to the subsidy, but a recent Treasury report on DISC concludes that this "targeted" approach will not reduce the wasteful nature of the tax break. The Treasury report also points out that, although the change reduced the cost of DISC from $1.4 billion in 1975 to $0.9 billion in 1976, the cost is expected to rise to $1.8 billion by 1982.

The administration proposal: Repeal these two wasteful and unfair subsidies

Under the Carter plan, both DISC and deferral would be repealed. The fight in Congress will be intense. On one side will be several hundred U.S. exporters and multinationals with a laundry list of long discredited arguments about why the boondoggles should be continued; on the other side, everybody else, including those who believe that Uncle Sam should not waste these billions on paying large corporations for investing abroad and for export activities they would undertake anyway, and individual taxpayers and other businesses, whose tax cuts will be endangered if the reforms are not enacted.

Arguments for DISC—Even the diehard defenders are running out of things to say

The DISC advocates are reaching the end of the line in trying to defend their wasteful tax subsidy. Originally, they had argued that DISC increased exports by reducing their prices abroad. In fact, that was the original, ill-advised idea behind DISC. If foreigners are unwilling to buy U.S.-made widgets for $1.00, perhaps they will buy them if they cost only 99 cents. But a direct price rebate on overseas sales would violate international trade agreements, so Congress tried to hide the subsidy by establishing the complicated DISC apparatus. Foreign governments aren't totally stupid, however, and they quickly pointed out that DISC appeared to be a violation of the treaty arrangements (as it certainly was intended to be). At first, DISC's defenders pointed to the foreign complaints as "proof" that DISC must be working to increase exports. When it became clear that the U.S. was not happy in being caught in apparent violation of the treaty arrangements, however, some DISC apologists abruptly shifted gears. Somewhat amazingly, they began to argue that DISC does not help U.S. exports. David Garfield, chairman of the "Special Committee for U.S. Exports," a group of export companies which have banded together to fight to retain DISC, recently told the Washington Post: "We don't pass on DISC benefits into lower prices and increased exports. We keep it as an incentive to us. We have more profit."

This, of course, is what DISC critics—and even honest DISC beneficiaries—have been saying for years.

Le Morgan, president of Caterpillar Tractor Co., told the Ways and Means Committee in 1975 that, although over 50 percent of his company's sales were overseas and DISC was worth $9 million to it in 1974, "I am not really sure that we did anything extra in order to generate additional exports, so that I suspect that I agree that not much has happened, at least in our company, to earn the tax deferral that has come from DISC."

DISC benefits end up in higher profits for the export companies rather than in lower prices on exports because the sales of most of the U.S. products affected—such as computers, jumbo jets, wheat (to the Russians), fighter planes, nuclear reactors, oil drilling equipment, and large houshold appliances, among others—are in such great demand worldwide that they are not sensitive to price changes. In fact, while profit margins on domestically sold goods run about 8.5 percent, the profits on DISC exports are double that amount—17 percent. And even if DISC did lower export prices, the maximum effect of the $1 billion subsidy on our $100 billion in exports would be only a 1 percent price cut. This is miniscule compared to other factors. By contrast, dollar devaluation alone has reduced export prices by as much as 30 percent in recent years.

Back when they were maintaining that DISC helped exports, the DISC supporters also claimed that DISC created jobs in the U.S. Does DISC really create U.S. jobs? If so, why are the AFL-CIO, the UAW, and the other major unions virtually unanimous in opposing it? In fact, numerous objective studies—by the Library of Congress, the Congressional Budget Office, and others—have shown that the money lost on DISC would create 2-3 times as many jobs if spent almost any other way (such as general tax cuts or direct government spending). And in the unlikely event that DISC has boosted exports in a few favored industries, the recent Treasury report on DISC suggests this may have buttressed the dollar, making foreign products relatively less expensive than they might otherwise have been, and, hence, increased imports of goods like shoes, textiles, and steel, costing jobs in our most hard-hit, labor-intensive industries.

Arguments for deferral: Charity for the multinationals?

Advocates of retaining deferral will maintain that this tax break is needed to help our multinational corporations compete abroad. This is an almost ludicrous claim. American-based multinationals are generally the strongest companies in the world in terms of trade. Most of their foreign investments are made in response to markets and labor and raw material costs overseas, and would be made with or without the deferral tax subsidy. But deferral does hurt companies like Zenith which try to do their manufacturing here in competition with companies like RCA which produces its t.v.'s abroad and imports them into the U.S. (Zenith has just announced that it is being forced to move some of its operations overseas, at the cost of thousands of U.S. jobs.) And it encourages companies to invest abroad even when it is otherwise economically unsound:

The president of Centronics Data Computer Corp. recently boasted to the Wall Street Journal about how his company had made the "hard decisions" to invest abroad in spite of poor labor efficiency, high costs, and lower pre-tax profits. "We traded pre-tax efficiencies for after-tax benefits," he bragged.

There is no U.S. interest in furthering such distorted, tax-based investment decisions, which only reduce needed investment and jobs here at home.

Repeal of DISC and deferral would be more than offset by the other business tax cuts in the President's program. Indeed, a Treasury analysis of the simulated effect of the tax package on 18 representative multinational corporations shows that only 3 of the 18 would owe any additional tax; the overwhelming majority would get a tax reduction. See appendix.

CORPORATE RATE CUTS

Administration proposal: Cut corporate rates by 10 percent and pray for "business confidence"

The Administration proposes to cut statutory tax rates on corporations by almost two points off the 20-22 percent rates now applicable to the first $50,000 in corporate profits, and four points off the 48 percent rate assessed on profits over $50,000.

A bad idea in search of a rationalization

Cutting corporate taxes is a terrible idea. Although large corporations are supposed to be paying at a 48 percent rate on most of their profits, the average rate actually paid has shrunk to about 25 percent due to the multitude of special business loopholes in the tax laws. See, for example, the Joint Committee staff report on Tax Policy and Capital Formation (April 4, 1977), page 11. It makes no sense to ask America's overburdened individual taxpayers and those in need of government assistance to bear the burden of further corporate reductions.

More corporate tax cuts are not justified either by capital spending needs or to compensate for inflation problems. Two senior economists at IBM noted in the December 15, 1977 issue of the New York Times that allegedly low after-tax profits are not the reason capital spending has lagged below what we might like:

"In general, an examination of the data suggests that the contention that profits are low by historical comparison is an exaggeration at best and inaccurate at worst," the IBM economists, Seymour Zimmelstein and Larry Chimerine, concluded. "In addition, profits are high relative to capital spending by historical standards and therefore are probably not the source of the current sluggishness in capital spending."

The November 1977 issue of Fortune alo reports that Burton Malkiel, chairman of the Economics Department at Princeton, has concluded that:

"There is no evidence to support the contention that inflation has hurt real corporate earnings. He suggests, instead, that profitability has been fairly constant over the long run—when earnings figures are adjusted for cyclical fluctuations in the economy and for the falling real value of fixed-income liabilities."

At one point, the Administration was defending corporate cuts as a trade-off for closing the capital gains loophole available to corporate shareholders. Since then, however, the Administration has abandoned its pledge to curtail the special treatment of capital gains. This move eliminates any purported justification for a corporate cut.

"Small business relief" that helps big corporations and wealthy individuals

Reducing the rates on the first $50,000 in corporate profits to 18-20 percent is supposed to be an aid to "small business." In fact, however, it is mainly tax relief for large corporations and wealthy individuals.

Under current law, small business corporations are able to avoid paying any tax at all so long as the owners agree to be taxed directly on the business profits. In fact, the overwhelming majority of small businesses are not even set up as corporations. Only when a small business is very profitable is it advantageous to run it as a separately taxed corporation.

For example, a businessman whose company earns $25,000 (more than what 90 percent of all American families earn) and who pays himself a $15,000 salary out of the profits, gets virtually no short-run advantage from incorporating, and in the long run is almost certainly better off not having a separately taxed corporation. The businessman with profits of $100,000 (more than what 99.9 percent of families earn), who pays himself a $50,000 salary, however, can save over $12,000 in taxes by incorporating.

In testimony before the Senate Select Committee on Small Business on Feb. 20, 1975, then Assistant Treasury Secretary for Tax Policy Fred Hickman pointed out who will benefit from lowering the rates on the first $50,000 in corporate profits:

"When we are talking about potential tax benefits for corporations with taxable income of $25,000, $50,000, or $100,000, we should keep in mind that those companies tend to be owned by persons who, by most of our standards, are considered wealthy. They tend to be closely held, and in many, if not most, cases the owner-managers have paid themselves salaries anl bonuses. Take, for example, a small retail corporation managed by its owner. Assume that he pays himself salary and bonus of $60,000 and that the corportion after deducting that amount has taxable income of $25,000. That $25,000 is, in effect, an amount saved by the owner. It is presently taxed at a [20] percent rate, even though his personal marginal rate is probably (depending on his exemptions and deductions) 50 percent or above and would be substantially higher if the $25,000 were also included in his income. The right to save $25,000 a year at a [20] percent tax rate is a very major tax benefit to persons in substantial tax brackets—which is where most owners of such corporations are. Ordinary taxpayers pay higher tax rates than [20] percent when their taxable income exceeds only $[8,000]."

Lowering the rate on the first $50,000 in profits only makes this high-income loophole even more attractive and lucrative to the few who can benefit from it.

In addition, the low rates on the first $50,000 in profits apply to big corporations as well as small. In fact, the largest 10 percent of U.S. corporations—the top 1.5 percent of all business entities—would get well over half the benefits of the Administration's proposed reduction in the rates on the first $50,000 in corporate profits.

The corporate rate cuts should be rejected

Every time individual taxes are cut to allow for inflation pushing people into higher brackets, business comes along asking for a handout—although their flat tax rates are unaffected by inflation. Repeating the pattern of recent years, the Carter plan accompanies its "stay even" individual cuts with a huge, real reduction for corporations. It's time this practice was stopped. The corporate rate cuts should be defeated.

Investment Credit

The problem: Tax breaks for the well-off, rip-offs from consumers, and tipping the balance away from jobs

In 1976, peanut farmer Jimmy Carter earned $53,000. After normal deductions, he and his wife Rosalyn had taxable income of $40,000—more than 98 percent of all American families. People lucky enough to have this high an income are supposed to pay about $11,000 in federal income taxes. But when the Carters figured out their tax liability, it turned out they owed zero! The reason: A large investment tax credit for buying new peanut processing machines. (An embarrassed President Carter subsequently sent the Treasury a check for $6,000, as the "minimum" tax payment he thought he should get away with.)

In 1976, the nation's private electric companies charged their customers for $3 billion in federal income taxes, but they actually paid only $562 million to the Treasury. The reason: Special tax breaks, mainly accelerated depreciation and the investment tax credit. (For more data on the taxes paid—or not paid—by utility companies, see attached appendix.)

In 1975, just five corporate giants collected over a billion dollars from the investment tax credit. One company, AT&T, picked up $750 million on its own! In 1977, the investment credit cost $11 billion overall, with close to 80 percent going to corporations with more than $250 million in assets each (the top 0.1 percent of all corporations). This represented $50 from each man, woman, and child in the country.

These examples illustrate some of the current problems with the investment tax credit. In addition:

As an investment "incentive," the investment credit is tremendously wasteful, because most of the investment it supposedly "encourages" would probably be undertaken anyway. This is not only common sense, but can be seen by looking at the major beneficiaries of the credit. 77 percent of the benefits go to the less than 2,000 corporations with assets over $250 million—the largest 0.1 percent of all businesses. For these capital-intensive industries, new machines are their life blood, and new investment is what they have to do, with or without a special tax break.

As a way of cutting corporate taxes, the investment credit is incredibly discriminatory. One effect is to tip the competitive balance further in favor of corporate giants and against small businesses, which typically do not gain much advantage from the tax credit because they tend to be much more labor-intensive. Like any tax cut, the investment credit makes more money available for private investment, but the subsidy is given to those who need help the least.

And as a jobs creation tool, the investment credit is misdirected, since if anything it encourages industry to replace workers with machines.

The investment credit helps many of our giant corporations pay low effective rates of income tax. For individual, unincorporated businesses its effects can be even worse. A striking example was provided last year when President Carter revealed that the investment credit had allowed him to reduce his tax liability on over $50,000 in income to zero! The credit is also one reason why millionaire independent oilmen are able to thumb their noses at the taxman every year.

There are some curbs on these kinds of abuses in current law, although they are pitifully inadequate. The major one is that the credit is not supposed to cut taxes for any taxpayer by more than half. This rule has its own loophole, however, which allows the first $25,000 in taxes—the amount due on a taxable income of $65,000—to be offset in full. This loophole was the reason President Carter was eligible to pay nothing last year.

Administration plan: Tokenism on fairness, lower taxes for big business, and aid to runaway plants

The Administration bill proposes to take a token step to close the "Carter loophole" by limiting the investment credit to 90 percent (rather than the current 100 percent of the first $25,000 in tax liability. This piddling "reform" would have required the President to pay only $1,200 in taxes in 1976—a 3 percent rate rather than the 15 percent he thought was a bare minimum.

Worse still, for even more well-off taxpayers the credit would be *broadened*, with the 90 percent rule applying across the board (replacing the current 50 percent limit). In addition, the credit would be expanded to cover new plants as well as new equipment.

90 Percent rule: Lower taxes for businesses with the most loopholes already

Allowing businesses to use the investment credit to wipe out all but 10 percent of their tax liabilities would allow some of our biggest companies to come close to taking themselves off the tax rolls entirely.

For example, capital-intensive airlines use artificially high depreciation deductions to reduce their taxable incomes to very low levels. Because of the 50 percent limit on the investment credit, however, many airlines were still paying something (5–9 percent) in federal taxes. In 1976, however, Congress established a special rule allowing the airlines to use the investment credit without limit (a 100 percent rule). The result: American, Eastern, and Pan Am, to name just a few, all paid nothing in taxes in 1976; United Airlines' credit jumped to $42 million in 1977 from $7 million in 1976.

In fact, the basic effect of the administration's proposed 90 percent rule would be to help businesses which are already taking advantage of other loopholes to reduce their taxable income to artificially low levels. Some reformers who have advocated a liberalized or "refundable" credit have relied on the idealistic premise that these other loopholes would first be repealed.

Applying the credit to structures: Helping jobs leave the snowbelt for the sunbelt, the cities for the suburbs

Extending the investment credit to new buildings will increase the advantage for industries to leave the Northeast and Midwest for the Sunbelt and to move from inner cities to the suburbs, further accentuating unemployment for minorities and already hard-hit areas. The administration tries to balance this by providing the credit for fixing up existing plants as well, but the overwhelming majority of the money will go to new structures.

Utilities, nuclear plants gain, consumers lose

Extending the investment credit to buildings would cost over a billion dollars per year. An amazing 40 percent of this would go to utilities, which would also get substantial benefit from the 90 percent rule. In many areas, utilities are already overexpanding their plants in response to federal tax subsidies. In fact, a recent study by Environmental Action Foundation found that some of the nation's private electric companies have excess generating capacity more than tripling the 15–20 percent maximum reserve capacity recommended by federal energy officials, and that overall the country has the equivalent of 50 large power plants worth of unneeded generating capacity. Thus, taxpayers must not only pay for the investment credit, but, as consumers, must also pay unnecessarily high electric bills. The extension of the tax credit to structures would exacerbate this problem. In addition, it is feared that much of the utilities' share of the expanded credit would be used for the construction of nuclear power plants, which for the first time could fully qualify for the credit.

Trying to set utility investment policy at the federal level through tax subsidies inevitably leads to overexpansion in some areas. State utility commissioners are the only ones in a position to judge a particular company's true capital needs, and they can provide for them when necessary through changes in utility rates.

The administration's proposed extension of the investment credit to structures would mean that utilities would pay virtually nothing in federal income taxes (although they would continue to charge their customers as if they did). The utilities could only achieve this zero-tax situation, however, so long as they continue to overinvest in new plants. A much better approach is contained in legislation introduced by Representative Pete Stark (D-Calif.). Stark's bill would take utilities entirely out of the federal income tax system, substituting a low gross usage charge to maintain federal revenues. This would eliminate federal pressure for needless expansion, and would return control of utility policy to state public utility commissions. In addition, it would vastly simplify the rate-making process, making it more accessible to citizen involvement. Finally, because the gross usage charge would be based purely on electricity consumption, it might help encourage conservation. Done right—as in Stark's bill—taking utilities off the tax rolls could be very beneficial. The administration's proposal, however, is the worst route possible.

PERSONAL TAX CREDIT

Currently, the tax laws provide a $750 exemption for each individual taxpayer and dependent (with extra deductions for aged and blind persons). There is also a "general tax credit" of $35 per exemption or 2 percent of taxable income (up to $9,000), whichever is greater.

For example, a family of four with total income of $16,000 can deduct $3,000 (4 x $750) from that income due to the personal exemptions. If the family does not itemize deductions, its tax would be a patriotic $1,776, but this is reduced to $1,596 by a $180 general tax credit.

Problems with current law: Higher benefits for the well-off and complexity for everyone

One problem with the $750 personal exemption is that it gives greater tax savings to individuals in higher brackets. For example, not having to pay taxes on $750 is worth $275 to a taxpayer in the 50 percent bracket, while a person in the 20 percent bracket saves only $150 for each exemption.

The general tax credit—originally added as a stimulus to the economy—is distributed in almost random fashion, at least in the lower and middle brackets. For example, a couple earning $8,000 gets $70 in tax savings from this provision, while a single person earning $12,000 gets $180.

In addition, the combination of credits and deductions is confusing and hard to deal with for taxpayers. Although the new tax tables for 1977 mostly eliminate the complicated arithmetic previously required, taxpayers still find it hard to understand how the system works.

The administration plan: One personal tax credit for everyone

The Carter tax bill would rationalize the personal exemption and general credit by combining them into a single personal credit of $240, for each taxpayer and dependent. Because it is a credit (which directly reduces taxes), this will give equal benefits to all individuals, no matter what their tax bracket.

The change to the new, $240 credit will be beneficial to average families (2 children) earning less than about $22,000. Eliminating the general tax credit will also reduce the "tax on marriage," because two-job couples will be entitled to the same credit whether or not they are married. (Currently, for example, two people each with income of $10,000 can forfeit almost $100 in general tax credit if they decide to marry—because of the $180 limit on the credit.)

The new personal tax credit, in conjunction with the across the board rate reductions also proposed by the President, will improve the progressivity of the tax system while lowering taxes for practically everyone. The change would remove some 6 million people from the tax rolls, and should prove especially beneficial to elderly retirees in low brackets, who will receive an extra credit for old age. It deserves full support.

Itemized Deductions

The problem: Higher benefits for the well-off, complexity in the tax system, and unnecessary intrusions into taxpayer privacy

Imagine a national energy plan which discourages conservation by subsidizing part of the cost of gasoline, generally only for the most well-off; a federal tax policy which encourages states to establish regressive sales taxes by paying part of the tax for the biggest spenders; and a national health insurance system which pays ⅔ of the medical bills of the wealthiest citizens but nothing at all for 80 percent of us. Sound crazy? Yes, but all these things are now in the tax code.

Current tax law allows certain personal expenses to be deducted in computing taxable income. The list includes state and local taxes of all varieties, interest payments, medical expenses, and casualty losses, among others. The rationale behind allowing itemized deductions varies with the particular deduction, and frequently the effects are not very well tied to the purpose. Mortgage interest and property tax deductions, for example, are supposed to encourage home ownership, but the biggest benefits go to those who need such help the least. In fact, most homeowners get no help from the deductions because they don't itemize.

This upside-down effect is true of all the itemized deductions. First, a person usually needs a fairly high income to have enough deductions to be over the "zero bracket amount" (formerly called the standard deduction). Because of this, a full three-quarters of all taxpayers don't qualify for any deductions. Even for itemizers, the tax savings from deductions increase with income—about 25 cents for each dollar deducted for a $16,000 taxpayer, but 70 cents on the dollar for a $200,000 taxpayer.

The cost of itemized deductions—which mainly benefit the well-off—is borne by the majority who don't itemize. And even those who do not itemize have to deal with complex rules and record-keeping requirements, and must tell the government a lot more about their personal affairs than they might otherwise prefer.

Administration proposal: Cut out the least justified deductions, limit two others, reduce the number of itemizers, and use the revenues to cut tax rtaes

The Carter program would eliminate some of the deductions which have the least justification, and restructure two others to achieve their purposes. The result would be a 40 percent less itemizers, and a fairer and simpler tax system.

The two principal deductions to be wiped out are the ones for state and local sales and gasoline taxes. No convincing reason has ever been offered for allowing these two items to be deductible; they have simply boot-strapped their way into the code along with income and property taxes. In fact, in 1961 the House voted to eliminate these deductions, and again last year the House tried to repeal the gasoline tax deduction. Both times, however, the Senate has rejected the move, without any good reason. Both sales and gasoline taxes are computed from tables, and the amounts deducted often have little to do with actual expenditures. In addition to complicating tax forms and unfairly favoring itemizers, the deductibility of these taxes also goes against some strong social goals. The sales tax deduction encourages states to rely on this regressive levy, in conflict with other federal policies designed to encourage states to establish progressive income taxes instead. The gasoline tax deduction is in conflict with the need to conserve our limited supplies of energy.

The Carter plan would also restructure the currently allowed deductions for medical expenses and casualty losses. These deductions have been criticized as being a kind of upside-down government insurance program: e.g., if you have medical expenses, the government will pay 70 percent of the cost if your income is very high, less if your income is lower, and nothing if you take the standard deduction. Others have noted, however, that medical and casualty expenses are usually (but not always) involuntary and unsatisfying expenses that really make some unfortunate taxpayers worse off than others.

The Administration proposes to continue these deductions, but only to the extent that they are really unusual expenses, different from what average taxpayers experience. To achieve this goal, the President's plan would combine the two items into a single "calamity deduction." Whenever a taxpayer spends more than 10 percent of his or her income on medical and casualty expenses combined, the excess would be deductible. This would offer protection to taxpayers who really need help, but it would largely remove the federal government from its "upside-down insurance" scheme. In addition, medical deductions would only be allowed for expenses customarily made primarily for health purposes. Swimming pools and sea vacations would be disallowed.

At first glance, it might seem strange to treat medical expenses and casualty losses together. After all, what does a stay in the hospital have to do with a house burning down? The purposes of the two deductions, however, are very similar: to give a break to taxpayers hard hit by unusual and unforeseen calamities. Looked at this way, putting the deductions together makes good sense. However, the Committee may wish to look at an approach which retains the separate treatment of each while raising and simplifying the existing floors.

Adoption of the Carter plan on itemized deductions would result in a major simplification of the tax system—decreasing the number of itemizers by 6 million, so that about 85 percent of all taxpayers would be able to compute their taxes using only the simplified tax tables with the zero-bracket-amount built in. It would also improve the integrity of the system, by curtailing much of the petty cheating which undermines fairness and respect for the tax laws. Because of the rate reductions which these (and other) reforms make possible, most itemizers would get a tax cut, while at the same time their record-keeping burdens would be reduced and their privacy enhanced.

Fringe Benefits

The problem: Employer fringe benefit plans use tax brekas to discriminate against rank and file workers

The tax laws currently do not require workers to pay tax on the value of certain employer-supplied benefits, including medical and disability insurance and group term life insurance (up to $50,000 in coverage). In addition, employees can put off paying taxes on amounts set aside in pension plans until they actually receive the money at retirement.

Like most special exemptions and deductions, these tax breaks tend to provide their biggest savings to the highest paid employees. Nevertheless, they are defended because they encourage employers to provide needed benefits to all their workers. Current law, however, allows employers to discriminate in favor of stockholder employees and highly-paid executives in providing these fringe benefits. The Carter tax package would condition future tax-free status on elimination of these unfair practices.

Medical and life insurance plans, an outrageous situation

The current situation for health and life insurance plans is particularly scandalous. Although the purpose of the tax exclusion is supposedly to help rank and file workers, employers can in most cases limit benefits solely to high-paid executives without sanction.

> In a not atypical case, for example, one corporation set up a medical plan which provided $54,000 in benefits for three officer-shareholders and their families, but not one penny in coverage for other employees.
>
> A national advertisement for "The Ultimate Tax Shelter" touts the advantages of incorporating a business to take advantage of "tax free fringe benefits." "You can set up your health and life insurance and other programs for you and your family wherein they are tax deductible." A major advantage is that none of these benefits have to be given to the regular employees of the business.

The Carter programs would generally require that health insurance be provided to all workers equally, and that life insurance, if provided to some, be made available to everyone (although the amount could be based on salary level).

Pension reforms needed, too

The existing pension laws do have some restrictions on discrimination, but there are serious flaws in the ways employers are allowed to combine or "integrate" their pension plans with social security. For example, some employers take advantage of the current rules so as to provide no coverage at all to workers earning less than the social security payroll tax "wages base"—currently $17,700 and rising to $29,700 by 1981. Taking account of social security benefits is not necessarily bad, but to allow lower paid workers to be totally excluded from tax-free pension plans because they are covered by social security is grossly unfair. This is especially true since one of the justifications for the tax break for pension plans is that social security alone does not provide adequately for retirement.

The Administration plan does not rule out allowing for social security benefits, but does establish fairer rules for doing so. Generally, it requires that for each 1.8 percent of salary above a certain limit (say, the payroll tax wage base) that is put into a pension fund, 1 percent of salary below the limit must also be put in.

For example, if $7,500 is set aside tax-free for a $50,000 executive, about $2,200 would have to be contributed for the $20,000 employee, and around $1,000 set aside for the $10,000 worker.

Looked at another way, if at 1978 levels the executive gets a $20,000 annual pension out of the just-described program, the $20,000 employee—who now could get as little as $1,250—must get about $5,400, and the $10,000 worker—who now could be totally excluded—must get about $2,700. Coupled with social security benefits, this would give the retired executive $25,840 per year, the $20,000 employee $11,240, and the $10,000 worker $7,100.

Only fair plans should get tax breaks

The Administration proposals would encourage employers to adopt fair plans for providing pensions and health and life insurance by denying tax breaks to the perpetrators of discriminatory plans that only help highly paid executives. It would affect only those plans currently designed primarily to shelter income for the highly paid. These important improvements deserve full support.

STATE AND LOCAL BONDS

The problem: High income individuals and corporations avoid taxes, while the subsidy to state and local governments is wasteful and inefficient.

> "Would you like to receive a monthly income check exempt from federal income taxes? If your answer is 'yes,' just mail the coupon. Save time! Call toll free day or night."—Wall Street Journal advertisement for tax-exempt bonds.
>
> The celebrated Mrs. Horace Dodge, heiress to the automobile fortune and always civic-minded, invested her inheritance in tax-free municipal bonds. The result: Zero tax on $1 million in interest a year!
>
> Commercial banks traditionally pay very little in federal income taxes. A major reason: In 1977, $114 billion of their investments, generating billions in interest, were in tax-exempt municipal bonds.

Since the beginning of our income tax system, the interest received on state and municipal bonds has been tax exempt. Originally considered a constitutional necessity, this tax preference is now usually defended as an aid to state and local governments, allowing them to borrow at lower than market interest rates. Because no federal tax is due on the interest earned by the bondholders, they are more willing to buy bonds at lower rates.

The first problem with this tax break is that it allows wealthy people to avoid taxes. In fact, 83 percent of the invididual tax savings from the exemption go to to the top 1 percent of all taxpayers. In addition, it is a very wasteful way to help state and local governments. The federal government currently foregoes some $6 billion in taxes because of the exemption, but states and cities save less than $4.5 billion in reduced interest payments. The reason for this difference can be illustrated as follows:

> The current market rate for taxable bonds is about 8 percent. A taxpayer in the 50 percent bracket would be willing to buy a tax-free bond paying only 4 percent, since this will yield the same after-tax gain as if he or she received 8 percent and paid a 50 percent tax. A person in the 70 percent tax bracket would accept a tax-free yield of only 2.4 percent. In order to attract a wider range of lenders, however, state and local governments have to set the interest rates on their bonds to appeal to taxpayers in the 30 percent bracket and up. This means they currently pay about 5½ percent—tax free. For short-term bonds and at times when credit is tight, the rate is even higher. This gives a windfall to taxpayers in higher brackets—a windfall paid for by the federal government and, ultimately the rest of us.

Administration plan: Direct federal interest subsidies—the taxable bond option

The Carter Administration proposes to give states and localities the option of issuing taxable bonds with a federal subsidy to the states and localities of 40 percent of the interest. This would allow them to issue 8 percent bonds, but actually have to pay only 4.8 percent, with Uncle Sam subsidizing the balance—no strings attached.

Although the federal subsidy will continue, it will be much fairer. High-bracket taxpayers now getting windfalls in tax-free interest will have to pay taxes on their income from bonds. People in lower brackets and tax-exempt foundations and pension trusts will find municipal bonds attractive purchases for the first time. Overall, the benefits of the subsidy will be spread more evently, rather than being given only to high-income taxpayers.

State and local governments will also be helped because the market for their bonds will no longer be restricted to taxpayers in high-brackets. For this reason, states and cities are generally supporting the taxable bond option. They realize that it will provide more benefits to them at less cost to the federal government, and that it will improve the equity of the tax system.

The "Taxable Bond Option" is a reform that is long overdue. It deserves full support.

Minimum Tax

Numerous provisions of the tax code provide ways for well-off taxpayers to avoid paying taxes on large parts of their incomes. As one way of reducing some of the worst abuses of these loopholes, Congress has imposed a 15 percent "minimum tax' on the income a person otherwise succeeds in sheltering with certain tax preferences. For example:

A businesswoman with $100,000 in capital gains is allowed to exclude $50,000 of the gain from her income subject to regular income taxes, but the half which is excluded may be subject to the minimum tax.

An oilman who uses the artificial percentage depletion allowance to write off the cost of an oil well many times over may have to pay the 15 percent tax on the income he shelters with the excess deductions.

Income sheltered by accelerated depreciation on real estate is also covered.

The idea behind the minimum tax is to make it impossible for people to avoid tax entirely on substantial amounts of income. Until the loopholes themselves are closed, this "safety net" is the only means we have to do this. Virtually 100 percent of the minimum tax now collected is paid by persons earning over $50,000—the top 1 percent of all taxpayers.

The problem: The 15 percent rate is often too low, many loopholes are not covered, and there's a loophole in the minimum tax itself

Unfortunately, the minimum tax does not apply to a number of kinds of sheltered income, including that sheltered by the major phoney write-off for oil and gas—so-called "intangible drilling costs." Even where it does apply, the 15 percent rate is often a very poor substitute for the amount the taxpayer should actually pay—sometimes as high as 70 percent. In addition, the minimum tax has its own built-in loophole, which allows some of the most wealthy tax avoiders to reduce or eliminate its impact. This "executive suite loophole" reduces the amount of sheltered income subject to the minimum tax by half of any "regular" income taxes paid on other, non-sheltered income. In other words, payment of income taxes on a portion of your income becomes a license to shelter another portion from both income taxes and the minimum tax. This is a principal reason why the minimum tax has not stopped the peddling of syndicated shelter partnerships.

For example, take an executive with a salary of $150,000 who invests in enough tax shelters to lower his taxable income to $100,000. Even if all his loopholes are in the list of items covered by the minimum tax, only about half of the $50,000 in sheltered income will be subject to the 15 percent levy. The rest will be exempt because of the deduction for half the regular taxes he paid. Perversely, if the individual had even higher earnings, the minimum tax might be avoided altogether.

In 1974, individuals with incomes over $200,000—the 70 percent bracket—used $3.7 billion in tax loopholes, but paid only $117 million in minimum tax—a 3 percent rate. The main reason: the deduction for regular income taxes paid (then 100 percent).

The administration's proposal: Take out the built in loophole

The Carter plan would remove the deduction for half of taxes paid from the minimum tax. It would retain a $10,000 exemption from the tax, so that people with relatively small amounts of sheltered income need not worry about the minimum tax.) This change would raise some $284 million in 1979—98 percent of which would come from taxpayers whose incomes exceed $100,000.

A step forward that should be enacted

This change would be an important step toward making the minimum tax a more effective tool against tax avoidance. Although it is nowhere near the same as actually eliminating the unfair loopholes that cause the problem, this strengthening of the minimum tax deserves full support.

CAPITAL GAINS "ALTERNATIVE TAX"

The problem: Unfair loophole for all capital gains, with a special break for the wealthiest taxpayers

During the campaign and through most of 1977 the President promised that he would eliminate the preferential treatment of capital gains. Perhaps the biggest loophole in the tax code, this preference allows half the income from the sale of "capital assets" like stocks and bonds and real estate to go untaxed. 85 percent of the benefits of this preference goes to the 5 percent of taxpayers with the highest incomes, and it is the principal reason why so many high income individuals pay far less than their fair shale of taxes. In fact, individuals with incomes over $200,000 on the average manage to style 40 percent of their incomes as "capital gains"—thereby excluding half this amount from tax.

For the wealthiest capital gain recipients there is an additional loophole. Called the "alternative tax," this provision allows individuals whose tax brackets exceed 50 percent to pay only 25 percent tax on up to $50,000 in capital gains. Without the special rule, a 70 percent taxpayer, for example, would pay a 35 percent tax on his or her capital gains.

The alternative tax loophole costs some $140 million per year, but benefits less than one taxpayer in a thousand, and less than 2½ percent of those taxpayers lucky enough to report any capital gains. All those using this loophole have incomes over $50,000, and 78 percent of them earn more than $100,000.

Administrative proposal: Leave the main capital gains loophole alone, but repeal the alternative tax

Pressure from business lobbyists caused the Administration to welch on the President's campaign pledge to eliminate the capital gains loophole, and the absence of this reform is a major hole in the Carter tax package. The Administration does propose, however, to repeal the alternative tax, so that high bracket taxpayers will at least pay tax on their capital gains at half the rate they should.

This reform—although far more modest than what was previously promised—is an important one and deserves to be enacted. It not only will make the tax system fairer, but will eliminate one of the most complex provisions in the individual income tax system.

UNEMPLOYMENT BENEFITS

The problem: Tax-free unemployment benefits can be a boondoggle for well-off recipients

Unemployment compensation benefits paid under government programs are currently exempt from tax. For most recipients this is a plus, but not one of great magnitude. The $12,000 a year worker who is laid off long enough to receiver $1,200 in unemployment, for example, only saves about $250 from the exclusion—and if he or she were taxed, benefits might have to be raised to make up the difference.

A small but significant number of those drawing unemployment, however, take advantage of the system, getting untaxed unemployment checks although their annual incomes are quite high. In fact, individuals earning over $50,000 per year—the top 1 percent of all taxpayers, save an amazing $51 million dollars a year because of the tax break for unemployment! Some examples of how this happens are as follows:

Pat and Terry have established an admirable method of allocating responsibility for taking care of their children. Pat works from January through June; Terry, from July through December. Being highly-skilled and educated, they each earn $20,000 for their six months work. In addition, while they are "laid-off" each picks up $6,000 in unemployment compensation. Because this is currently tax-free, they have over $5,000 in income taxes.

Dale likes to live well, but prefers not to work the whole year. In six months he is able to pick up $10,000, and in addition he has interest and dividend income of $15,000. On top of all this he gets $6,000 in unemployment compensation tax-free—the equivalent to him of over $9,000 in additional taxable earnings.

Administration proposal: Tax unemployment benefits received by high income taxpayers

The Administration would tax part or all of unemployment compensation in situations where tax-free status is a particular abuse. Specifically, where total income (including unemployment) exceeds $20,000 (or $25,000 if married), 50 cents in unemployment benefits for each dollar over the limit would be subject to tax. For example, a single person earning $17,000 plus $5,000 in unemployment would have $1,000 of the benefits taxed. A couple earning $30,000 plus $5,000 in unemployment would be taxed on the full amount of their benefits.

The situations covered by the Administration proposal are relatively rare, and the great majority of Americans receiving unemployment would not be affected. High-income people abusing the unemployment system, however, have no right to favored tax treatment, which costs average taxpayers some $200–300 million per year. The Administration's plan deserves support.

TAX SHELTERS

The problem: While average taxpayers pay and pay, some wealthy people thumb *noses at the tax system*

Pick up any issue of the Wall Street Journal (or any other business-oriented publication) and you will see dozens of ads promoting ways to "shelter" income from taxes. On the eve of Christmas eve 1977, the following were some of the goodies offered by aggressive promoters:

Tax Shelter—5 to 1 cattle breeding shelter available for corporation. Invest $400,000 over next 5 years, write off over $2 million.

400 percent Shelter.—August 1976 coal lease. . . . For attorney or accountant with large individual or corporate clients.

5:1 Tax Shelter.—Excellent opinion letter in the agricultural area.

3:1 Tax Shelter Available in Good Investment Opportunity in Missouri.

Stable Cash Flows—Low Risk.

This Cable Television System is immediately available to qualified buyer.

After Barbara Walters accepted her $1 million contract with ABC, it's reported that the following conversation ensued when she consulted her lawyers to find out what her tax liability would be on her new salary: "How much will I owe," she asked. "How much do you want to pay?" replied the lawyers. "You tell us, and we'll arrange it."

The existence of tax shelters is a scandal in the American tax system. Combining Congressionally sanctioned tax preferences, innovative arrangements, and aggressive assaults on the edges of legal behavior, these tax avoidance schemes allow many high income persons to pay far less than their fair share in taxes.

HOW SHELTERS WORK

The essence of a tax shelter is to generate artificial "losses," which high-income taxpayers can use to shield their salaries and other earnings from income taxes. For example, if a taxpayer invests in property for which he can take accelerated deductions, he can use the excess deductions to offset other income that would otherwise be taxed at high tax rates in the year earned. Using the rapid write-offs postpones payment of the tax to a later year when the deductions are used up or the property is sold. Even just this postponement is of great value to high-income taxpayers—it's the equivalent of the government making a loan of the taxes owed, without requiring interest or collateral. The advantages of this tax deferral can be substantially enhanced by making the investment with borrowed money. By doing so, taxpayers can generate paper losses far in excess of the amount they actually invest (such as the "5 to 1" and "400 percent" shelter opportunists listed above). And when the day of reckoning for paying the deferred taxes comes along, taxpayers often find that their income has been converted into a capital gain (taxed at only half the regular rates), or they invest in new shelters to offset their taxes again, or, sometimes they simply cheat on reporting the later income—on the unfortunately valid assumption that IRS will have trouble catching them. And for some shelters, notably oil and gas, the day of reckoning never arrives. Excessive write-offs for the artificial percentage depletion allowance are a permanent tax shelter. A typical shelter deal works as follows:

> A syndicate composed of high income lawyers and executives obtains through a promoter the rights to a master recording of "A Treasury of Great Disco Hits." The purchase price is artificially set at $1 million, but the investors put up only $100,000, ostensibly "borrowing" the $900,000 balance from the record producer. Although the record (advertised on late night TV) is predictably a flop, the investors take $1 million in tax deductions based on the inflated price—getting, at least in the short run, the equivalent of a 400 percent tax-free return on their investment. As for the $900,000 "loan"—as planned, they quietly never repay it.

WHY SHELTERS ARE BAD

The most obvious reason why tax shelters are bad is that they provide ways for high-income people to avoid paying their fair share of taxes—and thereby make the rest of us pay more. In addition, the very nature of tax shelter investments is wasteful.

Many tax shelters—billions of dollars worth annually—are "packaged" by promoters who get commissions for their services which sometimes approach 50% of the investment. Even if the investments were economically sound, this means that an extraordinary portion is siphoned off by middlemen. But because of the tax benefits of shelters, the investments don't have to be economically sound to be profitable to high-bracket taxpayers. Because of tax deferral and capital gains rates, among other things, an investment can lose money, while still providing significant economic benefits to wealth taxpayers.

1976 REFORMS INADEQUATE

The 1976 Tax Reform Act attempted to curtail the opportunities for tax shelters by limiting write-offs to the amount an investor actually puts up or is personally liable for (except for real estate investments). Many optimists felt that this so-called "at risk" rule, by eliminating deductions for inflated, "borrowed" amounts, would clamp down on much of the tax shelter business. They failed to anticipate, however, the ingenuity and aggressiveness of shelter promoters. 1977—the year most of the new rules took effect—was a record year for shelter offerings. Promoters advertised shelters with increased zeal and high-bracket taxpayers continue to invest in them, relying on real or imagined loopholes in the '76 Act and on IRS' inability to police the activities. Descriptions of shelters which continue to flourish appear in the attached appendix.

Administration proposal: Close some of the remaining loopholes and help IRS enforce the law

The Carter plan is primarily designed to reduce the opportunities for abuse of the '76 reforms. To deal with shelters in general, the following proposals are made:

> Simplify and generalize the "at risk" limitation to eliminate any "arguable" ways around it. The "at risk" requirement would be extended to cover all activities (except real estate) and all individuals, partnerships, and closely-held corporations (5 or fewer shareholders owning 50% or more of the stock).
>
> In an attempt to deal with syndicated shelters, "limited partnerships"—the favored legal form for shelters because they combine lack of personal liability on debts for the investors with flow through of tax losses—would be treated as corporations if they have more than 15 members. (Those partner-

ships investing in residential real estate would be excepted.) Treatment as a corporation would deny to the investors the benefits of phony write-offs.

To crack down on sleazy promoters, IRS would be authorized to audit partnerships and determine investors' tax liabilities at the partnership level. Currently, some schemes prosper even though illegal because IRS has to deal with each partner individually.

The "deferred annuity" loophole: Stop it now before it grows into the "ultimate loophole"

The Carter proposal also deals with a budding tax avoidance scheme called "deferred annuities." Utilizing these devices, some high bracket taxpayers are able to avoid paying tax on their dividends, interest, and capital gains almost indefinitely, merely by styling their investment accounts as "annuities." Some of the sales literature for these "tax shelter annuities" reveals how seriously they could undermine the tax system:

> How do you want your interest, with or without current taxes?
>
> You no longer need to pay current taxes on interest and dividend income when you utilize the benefits of a tax-deferred investment annuity.
>
> Now you can defer income taxes on current interest and dividend income on your savings accounts and other assets ($10,000 minimum). The annuity policy permits the owner to direct the choice of permitted investments and to change investments, both before and during retirement.

The Carter plan would allow individuals to set up one tax-deferred annuity for retirement purposes and contribute up to $1,000 per year to it. The income from any other "deferred annuities," however, would be taxed as earned.

Important reforms with one major weakness

The Carter tax shelter reforms are necessary and important. As tax shelter promoters become more and more desperate for new loopholes, and consequently more and more unscrupulous, the new authority for IRS to police partnerships will become increasingly fruitful. Perhaps the major weakness in the proposals is the attempt to deal with tax shelter syndicates. The 15 member rule will be easily avoided by most promoters, but could actually inhibit some legitimate businesses with bona fide reasons for operating as limited partnerships. A far better method would be to crack down on syndicated partnerships—those that must register with the Securities and Exchange Commission or State agencies or those that are sold by registered brokers. (In fact, Congress has already adopted such an approach with regard to the required accounting methods for farm syndicates.)

Overall, the Carter plan for tax shelters is modest, but beneficial.

Real Estate Shelters

The problem: The sacred cow of tax shelters

Along with oil and gas, real estate investment is the main tax shelter which Congress intentionally allowed to survive the 1976 Tax Reform Act. The basic elements of this tax dodge involve construction of buildings, largely with borrowed money, and writing off depreciation far in excess of the wear and tear or loss in market value which actually occurs with the passage of time. These phantom depreciation deductions are used by high bracket taxpayers to shelter their salaries and other income from tax. For example:

> A group of corporate executives puts up $300,000 to finance a $3 million new luxury apartment building (the rest is borrowed). Although the completed building generates only $10,000 in annual cash flow (a 3 percent return on the investment), the executives are happy. They are able to write off $750,000 in the first five years of the project as "depreciation"—although the building has actually increased in value over that period. They use these phony deductions to shelter $750,000 of their salaries—which would otherwise have been taxed at 50 percent. These tax shelter deductions are the equivalent of a 25 percent per year tax-free return for the 50 percent bracket businessmen—or the equivalent of a 50 percent taxable return!

The February 1978 issue of *Money Magazine* reports: "Financial institutions are investing unprecedented amounts in real estate, as are foreign buyers. And the Tax Reform Act of 1976 left real estate the pre-eminent tax shelter." *Money* cites the following syndication example:

"One syndicate that's been outstandingly successful is SB Partners, managed by the real estate affiliate of Smith Barney Harris Upham, a large brokerage house. SB Partners began operations in 1971. At the end of 1977, an investment unit that originally cost $10,000 had an estimate vaue of $14,000—and a unit holder had received capital gains totaling about $7,800 plus tax sheltered income of $3,508. In addition, he had tax deductions aggregating $18,816."

Similarly, Business Week reported on August 1, 1977:

> "Robert Rohdie, who once ran the real estate department at Donaldson, Lufkin & Jenrette and now has his own investment company says: 'There has been a tremendous resurgence in the market. The individual who wants tax advantages is choosing real estate, and prices are going nuts.'
>
> "In Houston, for example, Underwood Neuhaus & Co. has put together 10 syndicates in the past year and raised $50 million, mostly for apartment construction. Says John R. Biggs Jr., manager of the syndicates: 'We're seeing a great proliferation of mediocre product. Right now, if anything, it's too easy to sell.'"

The favored status of real estate shelters has always been defended as justified because of the assistance the tax breaks allegedly provide to low and moderate income housing. Time and time again, however, real estate shelters have been shown to be ridiculously wasteful and inefficient in achieving their ostensible goal.

> A recent study by the Congressional Budget Office, for example, shows that only about $80 million of the $1.5 billion annual cost to the Treasury of real estate shelters results in actual assistance to low income housing construction. The rest of the lost revenues—almost 95 percent of the total—ends up in shopping centers, luxury high-rises, office buildings, windfalls to high-bracket investors, and, of course, the pockets of shelter promoters. The study also concludes that the limited amount of low-income housing which is assisted tends to be shoddily constructed and poorly maintained and managed, because the investors are interested only in tax write-offs rather than in maintaining the buildings.

The elements of the shelter: Short write-off periods, with beefed-up deductions at the beginning

There are two basic elements involved in generating accelerated write-offs for buildings. One is to assign an artificially low "useful life" to the structure. For example, a building which might reasonable be expected to last 60 years might be said to have an expected life of only 20. The result is that investors can take 60 years worth of deductions in only 20 years—thereby tripling their write-offs over that period. The second method of beefing up deductions is to use one of the methods of "accelerated depreciation" currently sanctioned by the tax laws. These depreciation rules allow investors to concentrate their write-offs in the early life of the building instead of spreading them out evenly.

The limited administration response: Only the worst will be hit

In spite of the overwhelming evidence about the lack of social utility of real estate shelters and in spite of the fact that they are a major means of tax avoidance for high income people, the Carter plan does not propose to wipe out the shelter. In the 1976 Tax Reform Act, most shelters were hit by a rule disallowing deductions for investments financed with loans unless the investor was actually personally liable to pay the debt. This "at risk" rule, however, was not applied to real estate, and the President does not suggest disturbing this exception. In addition, under the Carter plan real estate would continue to be written off much faster than it actually depreciates. What the President's program does do is to curtail some of the worst abuses in the area, which have given a special advantage to those willing to play fast and loose with the tax laws.

Under the Carter plan, investors would no longer be able to make their own subjective judgments about the useful life of a building—a system which encourages the aggressive to take advantage of IRS's inability to police them. Instead, a table of useful lives for different types of structures would be established, and all investors would be required to use it. The table lives which are proposed are not particularly realistic—in fact, they are based on the average of the artificially low lives claimed by taxpayers in the past, and are far below what IRS has previously "suggested" was reasonable. Nevertheless, establishment of fixed lives would curtail abuses by unscrupulous promoters and investors.

The most ironic summary of the impact of requiring use of fixed lives recently appeared in the Wall Street Journal, where a tax lawyer was quoted as complaining that the Treasury's lives (the average of those currently claimed) are "horrendous." "Where inflation raises property values," the lawyer moaned, "owners must use the Treasury's lives to get depreciation."

The Carter plan would also cut back the use of accelerated methods of depreciation. Instead, investors would be limited to the "straight line" approach, under which a building is written off in equal installments over its useful life. For example, a $600,000 building with a useful life of 30 years would be written off at $20,000 per year. (Under some of the current approaches, as much as $40,000 per year could be taken in the early life of the building.) The Administration puts off the effects of this change for 3 years, however, for multi-family housing. And even after the 3-year "phase-in" is completed, low-income housing would still be allowed 150 percent write-offs in the early years.

The shelter will remain—but there are improvements

The Carter plan will not eliminate real estate as an attractive tax shelter. Even under the new useful lives table and straight-line depreciation, write-offs will often more than double actual losses, and the continued exception from the "at risk" rules will allow taxpayers to finance these deductions with borrowed money. In fact, if the Administration's proposals to curtail other shelters are successful, there could be a boom in the use of real estate shelters.

Nevertheless, the Carter program does offer substantial improvements over current law, and it deserves to be enacted.

BANKS AND SAVINGS & LOANS

The Problem: Banks and Savings & Loans Use Phoney "Bad Debt" Deductions to Pay Less Than Their Fair Share of Taxes.

Current law allows commercial banks, savings and loans, mutual savings banks, and other such institutions to shelter large portions of their income with artificially high deductions for "additions to bad debt reserves." The result of these special tax preferences is higher taxes for average Americans.

The concept of "bad debt reserves"—generally the money a bank sets aside to protect itself against the predictable percentage of loans that will go sour—is a rather esoteric one. But the practical effects of overstating the reserves for tax purposes can be readily understood. It means the financial institutions pay substantially less than they should in federal income taxes. Between 1955 and 1966, commercial banks took bad debt deductions totalling $5.7 billion. This exceeded their actual losses by $3.6 billion—and cost the Treasury some $1.7 billion! The rules were tightened in 1969, but, even so, between 1969 and 1975 excess deductions were over $400 million. The '69 reforms will finally phase out the phony deductions for banks by about 1982, but if the loophole is not closed *now* the Treasury stands to lose over $300 million between 1979 and 1982. These lost revenues will have to be made up by higher taxes on ordinary taxpayers.

> Bank America—the nation's largest bank—reported at the end of 1976 that its actual bad debt reserve was $278 million, but its cumulative federal tax write-offs had totaled $503 million—for a tax saving of over $110 million for this one institution.

The situation for savings and loans and other "thrift institutions" is even worse. Their "bad debt" deductions are typically three to six times their actual losses! Unless changes are made, this tax break will cost the Treasury $4 billion between 1977 and 1982.

FEDERAL TAX PROFILES OF RANDOMLY SELECTED SAVINGS & LOAN CORPORATIONS (1976)

[Source: SEC annual reports]

	Net income before taxes	Federal income taxes paid	Tax savings from bad debt provisions	Cumulative untaxed earnings
Financial Federation	$22,630,000	$5,431,000	[1] $3,847,000	$92,180,000
California Financial	11,491,000	2,747,000	[1] 2,068,000	[2]
First Charter Financial	113,358,000	24,365,000	21,528,000	[2]
Imperial Corp. of America	65,824,000	14,766,000	11,128,000	213,545,000
Financial Corp. of Santa Barbara	12,302,000	3,124,000	[1] 2,337,000	[2]
Golden West Financial	30,916,000	3,249,000	[1] 4,636,000	[2]

[1] Net of minimum tax.
[2] Not available.

As the chart shows, for example, one savings and loan—First Charter Financial Corporation of California—saved $21.5 million in 1976 alone, due to artificial bad debt deductions over and above actual losses.

Administration Proposal: Eliminate the Artificial Deductions for Commercial Banks and Lower the Exemption for Thrift Institutions.

Under the Administration proposal, commercial banks would no longer be allowed to use phony bad debt deductions to shelter their income from taxes. Instead, they would have to base their deductions on their actual experience. Thrift institutions—which now get a "bad debt" tax exemption of 50 percent of their net income—would be limited to a 30 percent deduction.

The reasons for allowing phony bad debt deductions have never been clear, and those which have been suggested have never made sense. For example, it has been argued that allowing large allocations to bad debt reserves helps protect banks and thrift institutions during hard times. But the tax savings from the artificial deductions are not required to be set aside for rainy days in cash or liquid assets—and, in fact, they aren't. It is also frequently said—at least for savings and loans—that the role these institutions play in the home mortgage market justifies the excess deductions. But the excessive bad debt write-offs have virtually nothing to do with encouraging the supply of home mortgages. Other factors—such as interest rates and the level of deposits—are the real determining factors.

The Carter proposals will improve the fairness of the tax system and help reduce the tax burden on average taxpayers. They deserve support.

High-Living Executives Whooping It Up on Luxury Yachts Are Cheating You Out of Tax Millions

High-living executives are enjoying luxury cruises and lavish parties abroad huge, gleaming yachts—and cheating you, the taxpayer, out of millions by writing off their floating fun as "business expenses."

And the Internal Revenue Service is openly abetting the swindle by allowing the executives outrageous deductions, an Enquirer probe reveals.

"These tax write-offs for yachts are nothing more than downright fraud!" thundered Congressman Fortney H. Stark (D.-Calif.), a member of the tax-writing House Ways and Means Committee.

Congressman Philip Crane (R.-Ill.) agreed.

"We should never allow these outlandish 'business expense' deductions for yachts.

"A yacht can be used for only one thing—pleasure!"

Added Donald Lubick, former tax legislative counsel with the Treasury Dept.:

"Deductions for this kind of thing should be disallowed. The yachts certainly aren't essential to the executives' business.

"They can conduct their business in offices like the rest of us."

The deductions claimed for yachts are never peanuts.

The heads of one major industry recently bought a yacht for $400,000, used it exclusively for pleasure—then tried to write off $273,000 of the yacht's operating costs.

Executives give incredibly flimsy reasons for justifying such write-offs—and even more incredible, the government accepts their reasons far too often. Examples of yacht deductions include:

A New Orleans corporation executive deducted the expense of taking clients on fishing trips. His reason: on the way to the fishing grounds, he showed them one of his products in use on an offshore drilling rig.

Executives of a California paint company wrote off 75 percent of the expenses of a company-owned yacht by claiming they were testing marine paint on the boat's hull.

A Miami race-track executive was able to deduct a third of his yacht expenses by claiming he used the boat "to cultivate and retain the friendship of other officials, track owners and others."

It's common for entries to be made in ships' logs to help the owner justify writing off on-board pleasure as a "business expense," revealed retired yacht skipper Monte Gothberg of North Miami, Fla.

"Some yacht owners will go ashore and call on a business client for only 5 minutes.

"Then they put in the ship's log that they were using the boat for business!" he said.

"I know of one outboard motor manufacturer who keeps four or five of his motors on display on the bridge of his yacht.

"Whenever he docks, he phones his agent in that town and says: "How are you? If you need any motors, I've got them.'

"Then he puts in the ship's log that he was on company business."

Gothberg said wealthy executives entertain as lavishly aboard the floating palaces as they do at home. "One 240-foot yacht I served aboard had a private bath with each stateroom, a galley and even a dining room."

Captain Irwin Jenkins of North Palm Beach, Fla.—who began skippering yachts in 1936—agreed that life on the boats is incredibly plush.

"We'd stock the yacht with the best of everything." Jenkins told The Enquirer.

"We'd get whole cases of the best booze, the best cuts of beef.

"Nothing was too good for our guests."

Another yacht captain, who asked that he not be identified because he'd lose his job, told The Enquirer he has even shipped $125-a-day call girls on board "to amuse executive guests."

"I'd falsify the ship's log for tax purposes—I'd describe the girls as ship's workmen," he admitted. The captain revealed some other tricks that executives use:

"They set up phony corporations to operate the yachts as charter boats. Then if they want to take a cruise or throw a party, they 'lease' the yacht. The lease fee then becomes a tax-deductible item.

"They make sure the yacht isn't leased enough during the year for the charter corporation to show a profit. This lets them write off operating costs on their income tax returns.

"They get the captain to falsify the ship's log to make entertainment look like business. For instance, when a company boss is living it up on the yacht, he has the skipper write in the names of many guests who weren't there.

"The 'guests' are always real people—they have to be, in case the IRS checks up on them. But they're the boss's friends.

"He just rings them up and says: 'You were on the boat Tuesday to Thursday this week, okay?'

"And of course, one company boss can always entertain another for a week or so. They'll have a nice holiday with their wives—or girl friends—then say it was a business trip that unfortunately didn't result in any business."

Rod Williams, of the yacht-managing firm of Whittemore and Williams in Greenwich, Conn., said executives sidestep IRS audits of their yacht-chartering firms by selling the yachts and dissolving the firms every three or four years. "The IRS only audits these firms every 5 years," he explained.

IRS spokesman Hoby Euringer said the government is aware tax loopholes are being used but doesn't keep close tabs.

He added: "I don't see anything illegal about it . . . but they are circumventing the intent of the law."

A full audit of this shocking situation has never been made. But in 1960, a partial study by the Treasury Dept. showed 881 corporations claiming deductions for "business entertainment" on yachts.

Treasury agents discovered that a whopping 60 percent of the claims were illegal.

In 1962, tax deductions for yachts were restricted by Congress. Yacht owners must now use their boats for business purposes more than half the time.

But as Williams and others involved in yachting pointed out to The Enquirer, it's shockingly easy for business executives to disguise pleasure as legitimate business—and thereby take you, the taxpayer, for a very expensive ride.

SIMULATED EFFECT OF TAX PROPOSALS ON 18 REPRESENTATIVE MULTINATIONAL CORPORATIONS, 1974 LEVELS OF INCOME

[In millions of dollars]

Company	Effect of proposed changes				
	Rate cut to 44 percent	Termination of DISC	Termination of deferral	Increased investment tax credit	Total changes
A	−35.2	14.5	4.4	−2.2	−18.5
B	−2.3	1.2	4.7	−.8	2.8
C	−2.0	11.8	−13.7	−.3	−4.4
D	−26.8	14.4	8.1	−2.8	−7.0
E	−20.9	5.4	5.0	−2.0	−12.5
F	−.7	3.0		−.5	1.7
G	−13.1		.4	−.2	−13.0
H	−3.8		2.1	−.5	−2.2
I	−4.6	.5	−.3	−1.2	−5.6
J	−14.9	2.5	4.1	−3.9	−12.1
K[1]					
L	−16.2	8.8	32.8	−4.7	20.6
M	−5.4	.7	2.7	−1.3	−3.3
N	−6.1		2.2	−.6	−4.5
O	−11.3	8.7		−.1	−2.7
P	−90.7		38.0	−1.9	−54.5
Q	−24.1	15.5	14.7	−7.1	−1.0
R[1]					

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Note.—Detail may not add to totals due to rounding.

[1] These companies had sufficiently large losses in 1974 to offset all tax liability under 1977 law or proposed law.

The figures in the table must be interpreted with care; they do not represent an estimate of the actual impact of the tax proposals on these particular companies in some future year. Rather, they are simulations of the impact of the tax proposals on the 1974 tax liabilities of the companies, assuming that 1977 tax law would otherwise prevail. In particular, this means that substantive changes in the tax law between 1974 and 1977—the increase in the investment credit from 7 to 10 percent, and the denial of DISC benefits for base period exports (which is estimated to have reduced original DISC benefits by 35 percent)—were taken into account before estimating the effect of the administration's proposals.

PRIVATE ELECTRIC COMPANIES—TAXES AND EXCESS GENERATING CAPACITIES, 1976

[Source: Environmental Action Foundation]

	Phantom taxes				Generating capacity			
	S	T	U		K		L	
	Federal income taxes charged to customers (dollars)	Federal income taxes paid (dollars)	Tax overcharge [1]		Reserve margin		Excess capacity [1]	
			Dollars	Rank	Percent	Megawatts	Percent	Rank
Alabama Power Co. (SC)	29,946,507	−9,578,579	49,525,086	11	33.8	1836	13.8	[2] 37
Appalachian Power Co. (AEP)	24,516,198	−533,508	25,049,706	24	42.5	1575	22.5	[2] 15
Arizona Public Service Co.	−201,238	−964,767	763,529	95	30.5	645	10.5	48
Arkansas Power & Light Co. (MSU)	18,156,619	−9,625,253	27,781,872	20	31.8	1030	11.8	[2] 42
Atlantic City Electric Co.	11,495,656	663,505	10,832,151	55	29.6	305	9.6	51
Baltimore Gas & Electric Co.	19,044,120	−1,469,257	20,513,377	27	31.5	1020	11.5	47
Boston Edison Co.	26,155,005	0	26,155,005	21	47.4	934	27.4	10
Carolina Power & Light Co.	79,845,850	−435	79,846,285	7	29.3	1500	9.3	53
Central Hudson Gas & Electric Corp.	6,260,700	3,326,000	2,934,700	88	18.8	114	0	[2] 85
Central Illinois Light Co.	14,468,093	2,566,800	11,901,293	51	29.5	285	9.5	52
Central Illinois Public Service Co.	18,249,666	4,045,400	14,204,266	41	23.2	383	3.2	72
Central Louisiana Electric Co.	3,255,261	−958,865	4,214,126	83	52.2	470	32.2	7
Central Maine Power Co.	8,008,757	2,063,751	5,945,006	79	16.4	179	0	[2] 85
Central Power & Light Co. (CSW)	23,672,297	6,743,000	16,929,297	32	58.8	1150	38.8	5
Cincinnati Gas & Electric Co.	10,422,415	7,081,074	3,341,341	85	31.8	826	11.8	[2] 42
Cleveland Electric Illuminating Co.	13,363,986	5,735,145	7,628,841	66	22.9	719	2.9	73
Columbus & Southern Ohio Electric Co.	7,194,000	−937,154	8,131,154	64	21.1	365	1.1	[2] 28
Commonwealth Edison Co.	167,725,831	11,291,661	156,435,170	1	26.4	3413	6.4	[2] 64
Community Public Service Co.	3,721,826	1,939,944	1,781,882	91	(3)	(3)	(3)	(3)
Connecticut Light & Power Co. (NU)	6,298,041	185,911	6,112,130	76	65.2	1288	45.2	3
Consolidated Edison Co. of New York	98,479,897	15,299,976	83,179,921	5	36.9	2799	10.9	28
Consumers Power Co.	54,545,087	40,517,935	14,027,152	42	26.7	1127	6.7	62
Dallas Power & Light Co. (TU)	16,362,770	5,016,391	11,346,379	53	35.4	837	15.4	[2] 3
Dayton Power & Light Co.	14,554,100	7,927,800	6,626,300	73	39.8	700	19.8	[2] 25
Delmarva Power & Light Co.	−87,193	−890,658	803,465	94	47.8	621	27.8	9
Detroit Edison Co.	42,619,561	3,121,882	39,497,676	16	29.8	1974	9.8	50
Duke Power Co.	126,539,796	347,653	126,191,143	2	45.4	3889	25.4	11
Duquesne Light Co.	13,589,632	9,831,700	3,757,932	84	21.6	488	1.6	[2] 77
Florida Power & Light Co.	76,589,129	−49,013,972	125,603,101	3	17.5	1332	0	[2] 85
Florida Power Corp.	43,360,527	−7,513,087	50,773,614	10	10.1	357	−4.9	95
Georgia Power Co. (SC)	80,586,404	505,000	80,081,404	6	33.8	2871	13.8	[2] 37
Gulf Power Co. (SC)	12,718,737	4,185,205	8,533,532	62	33.8	360	13.8	[2] 37
Gulf States Utilities Co.	29,503,383	13,412,952	16,090,431	35	36.0	1499	16.0	30
Harford Electric Light Co. (NU)	3,148,567	−63,926	3,212,493	87	69.4	725	49.4	1
Hawaiian Electric Co.	11,050,367	4,674,463	6,375,904	75	36.6	324	16.6	29
Houston Lighting & Power Co.	88,578,300	39,007,881	49,510,419	12	19.4	1591	0	[2] 85
Idaho Power Co.	17,586,281	−984,700	18,570,981	29	12.2	228	−2.8	93
Illinois Power Co.	30,237,851	13,823,000	16,414,851	34	41.6	1070	21.6	22

Indiana & Michigan Electric Co. (AEP)	−20,808,904	455	−20,870,359	100	42.5	1128	[2] 22.5	[2] 15
Indianapolis Power & Light Co.	18,411,302	3,890,000	14,521,302	40	51.4	859	31.4	8
Jersey Central Power & Light Co. (GPU)	28,448,347	18,430,277	10,018,070	56	23.4	547	3.4	[2] 69
Kansas City Power & Light Co.	10,032,282	6,273,943	12,758,339	46	42.0	806	22.0	[2] 10
Kansas Gas & Electric Co.	11,919,200	6,000	11,913,200	50	21.9	306	1.9	[2] 75
Kansas Power & Light Co.	9,678,780	82,120	9,584,610	58	18.1	267	0	65
Kentucky Power Co. (AEP)	6,711,529	2,141	6,709,388	71	42.5	228	22.5	[2] 15
Kentucky Utilities Co.	10,989,908	8,590,834	8,309,074	63	26.6	437	6.0	63
Long Island Lighting Co.	9,354,122	−1,654,584	11,008,700	54	42.0	1143	22.0	[2] 20
Louisiana Power & Light Co. (MSU)	18,617,004	3,232,163	15,885,441	37	31.8	1003	11.8	[2] 42
Louisville Gas & Electric Co.	21,801,560	9,166,259	12,635,707	48	35.4	561	15.4	[2] 32
Massachusetts Electric Co. (NEES)	12,028,263	9,904,057	6,064,200	77	41.4	873	21.4	23
Metropolitan Edison Co. (GPU)	19,198,749	2,157,468	17,041,281	31	23.4	320	3.4	[2] 69
Minnesota Power & Light Co.	9,457,070	2,459,600	6,977,470	69	8.6	91	−6.4	97
Mississippi Power & Light Co. (MSU)	16,183,579	8,621,358	6,505,221	71	31.8	551	11.8	[2] 42
Mississippi Power Co. (SC)	12,846,068	3,447,530	9,398,538	59	33.8	381	13.8	[2] 37
Monongahela Power Co. (APS)	23,638,747	14,264,022	9,372,725	60	23.8	307	3.8	67
Montana Power Co.	6,678,051	−6,579,037	13,555,688	44	68.5	637	48.5	2
Nevada Power Co.	2,416,578	649,739	1,767,139	92	26.4	280	6.4	[2] 64
New Orleans Public Service Co. (MSU)	9,835,332	5,516,200	4,319,072	82	31.8	289	11.8	[2] 42
New York State Electric & Gas Corp.	6,719,280	1,613,550	5,105,730	80	21.5	435	1.5	80
Niagara Mohawk Power Corp.	13,824,000	0	13,824,000	43	34.4	1812	14.4	36
Northern Indiana Public Service Corp.	9,819,612	3,096,334	26,143,278	22	28.4	561	8.5	56
Northern States Power Co.	61,574,013	5,536,758	56,037,255	9	17.0	701	0	[2] 85
Ohio Edison Co.	8,834,920	−21,256,161	29,491,081	19	26.9	1027	0.9	59
Ohio Power Co. (AEP)	−3,162,724	316,119	−3,448,843	89	42.5	1740	22.5	[2] 15
Oklahoma Gas & Electric Co.	19,051,658	−2,838,000	21,889,658	26	30.4	1014	10.4	49
Pacific Gas & Electric Co.	−9,024,717	−23,725,233	14,700,516	39	15.9	1949	0	[2] 85
Pacific Power & Light Co.	1,868,176	−5,012,718	6,880,894	70	42.7	1221	22.7	14
Pennsylvania Electric Co. (GPU)	21,863,223	5,400,864	16,462,359	38	23.4	465	3.4	[2] 69
Pennsylvania Power & Light Co.	39,688,215	−11,203,249	46,891,464	13	43.5	1815	23.5	12
Philadelphia Electric Co.	69,031,637	−15,979,809	85,011,446	4	35.5	1893	15.5	31
Portland General Electric Co.	7,140,508	−1,809,067	8,949,575	61	4.9	116	−10.1	99
Potomac Edison Co. (APS)	12,527,060	5,874,300	6,652,760	72	27.0	417	7.0	58
Potomac Electric Power Co.	27,708,000	15,522,943	12,185,057	49	43.1	1,510	23.1	13
Public Service Co. of Colorado	20,465,923	13,112,000	7,353,923	68	10.5	235	−4.5	94
Public Service Co. of Indiana	62,280,411	21,435,010	40,845,401	15	39.8	1,116	19.8	[2] 25
Public Service Co. of New Hampshire	8,526,947	5,720,056	2,006,891	90	38.6	430	18.6	27
Public Service Co. of Oklahoma (CSW)	24,322,573	11,667,000	12,655,573	47	22.4	492	2.4	74
Public Service Electric & Gas Co.	75,915,391	6,972,556	69,942,835	8	40.8	2,527	20.8	24
Puget Sound Power & Light Co.	10,462,000	−1,214,556	11,676,556	52	28.9	716	8.9	54
Rochester Gas & Electric Corp.	3,102,325	−1,562,000	4,664,325	81	32.0	299	12.0	41
San Diego Gas & Electric Co.	7,012,503	1,054,664	5,957,839	78	28.7	492	8.7	55
South Carolina Electric & Gas Co.	21,881,017	−35,700	21,916,717	25	42.2	841	32.2	19
Sothern California Edison Co.	37,973,600	25,163,514	12,810,086	45	23.6	2,625	3.5	68
Southwestern Electric Power Co. (CSW)	16,859,250	828,200	16,031,050	36	20.2	427	6.2	84
Southwestern Public Service Co.	14,630,542	−132,572	14,763,114	38	21.6	417	1.6	[2] 77
Tampa Electric Co.	23,298,233	−7,643,009	30,941,242	17	24.6	417	4.6	66
Texas Electric Service Co. (TU)	35,996,377	16,279,861	19,716,616	28	36.4	1,196	16.4	[2] 32
Texas Power & Light Co. (TU)	43,285,979	12,486,569	30,799,410	18	35.4	1,595	16.4	[2] 32
Toledo Edison Co.	12,484,653	4,570,841	7,913,812	65	9.3	125	−5.7	96

See footnotes at end of table.

PRIVATE ELECTRIC COMPANIES—TAXES AND EXCESS GENERATING CAPACITIES, 1976—Continued

[Source: Environmental Action Foundation]

	Phantom taxes				Generating capacity			
	S	T	U		K		L	
	Federal income taxes charged to customers (dollars)	Federal income taxes paid (dollars)	Tax overcharge [1]		Reserve margin		Excess capacity [1]	
			Dollars	Rank	Percent	Megawatts	Percent	Rank
Tuscon Gas & Electric Co	9,908,311	0	9,908,311	57	50.4	492	30.4	2
Union Electric Co	42,902,004	18,584,000	25,318,064	21	21.6	1,036	1.0	[2] 77
—— Illuminating Co	180,765	0	180,765	98	62.3	537	42.3	4
Utah Power & Light Co	18,284,581	700,000	17,584,581	30	5.0	91	−10.0	98
Virginia Electric & Power Co	45,771,764	1,931,723	43,840,041	14	10.5	1,159	0	[2] 85
Washington Water Power Co	6,418,664	5,753,216	665,038	96	21.9	262	1.9	[2] 75
West Penn Power Co. (APS)	24,811,271	17,324,800	7,486,471	67	27.9	614	7.9	57
West Texas Utilities Co. (CSW)	11,171,200	7,906,000	3,203,000	86	21.2	164	1.2	81
Wisconsin Electric Power Co	18,816,956	15,883,800	2,933,156	88	21.1	668	1.1	[2] 82
Wisconsin Power & Light Co	18,767,817	18,305,236	482,581	97	26.8	295	6.3	[2] 60
Wisconsin Public Service Corp	18,197,250	16,872,300	1,324,960	93	26.8	250	6.8	[2] 60
Totals	2,449,445,564	374,492,147	2,078,087,417		[4] 30.5	[3]	[4] 10.5	

[1] Negative number indicates insufficient generating.
[2] Tie.
[3] Not meaningful.
[4] Average.

Note.—Heating company abbreviations:
APS—Allegheny Power System
AEP—American Electric Power Co.
CSW—Central and South West Corp.
GPU—General Public Utilities Corp.
MSU—Middle South Utilities
NEES—New England Electric System
NU—Northeast Utilities
SC—The Southern Co.
TU—Texas Utilities Co.

Ah, Tax Shelters—What Horrors Are Committed In Thy Name

A GOOD RESOLUTION FOR THE NEW YEAR: DON'T LET YOUR URGE TO BEAT THE TAX COLLECTOR GET THE BEST OF YOU—AS CAL-AM'S CUSTOMERS MAY HAVE

(By Paul Blustein with Ellen Melton and Sarah Hardesty)

In 1976 Congress tried to close a screaming loophole in the tax laws by limiting the use of nonrecourse loans as a means of gaining big tax shelters with relatively small investments. But it didn't close the loophole completely—much to the glee of Los Angeles-based Cal-Am Corp., which is run by a lawyer named Joseph R. Laird. Boldly exploiting what seemed a small remaining hole in the law, Cal-Am has resurrected nonrecourse-loan tax shelters into big business. In 1976 alone it reaped $39 million in cash, and its customers claimed several times that amount in tax deductions. From where Joe Laird sits, things look very good. Except for one thing, Complains a Cal-Am sales official: "We would have done a lot more business this year if the Securities & Exchange Commission hadn't been on our backs."

The SEC has characterized some of Cal-Am's shelters as a "massive, complex, nationwide scheme to defraud the public." The Internal Revenue Service is not very happy about the whole operation, either. Says Richard Fish, a West Coast tax expert: "In my opinion these guys are selling cute schemes that will not be sustained on audit by the IRS; the investor will lose his money and his deductions—and invite further IRS attention in the process."

What has Cal-Am been selling that is dangerous to investors and yet apparently irresistible to them? Two things. One is master recordings for phonograph records and tapes. The other is coal leases. When Congress cracked down on nonrecourse loans it did not explicitly ban them for individual investors in these two areas, plus a few others, like book manuscrips. Cal-Am's Laird is getting rich on this tiny loophole.

A nonrecourse loan deal works like this: You buy a book manuscript for say, $100,000, but you don't pay much of it in cash. You put down $10,000 in cash and sign a nonrecourse note for $90,000. Using accelerated depreciation you might be able to write off half the total investment in the first year. For a man in a 50 percent bracket, that tax writeoff would be worth $25,000. The following year he can take another big writeoff. But he put up only $10,000. Isn't he still liable for the $90,000 note? Not necessarily. If the book isn't panning out, he can walk away from it. That's what nonrecouse loans are all about: The "lender" has no recourse to the investor's other assets.

There's a little problem, to be sure. If you walk away after putting in only $10,000 but taking $100,000 in depreciation, Internal Revenue will want to see you. They will say that you owe them taxes on the difference between $10,000 and $100,000. But as long as you've got the cash to pay the taxes, never mind. You've at least had the use of the government's money for a couple of years.

And if you want to cut some corners, you can just "forget" about the loan and hope IRS forgets, too.

A few years back, this nonrecourse loan gimmick was extremely popular in oil and gas drilling programs, equipment leasing, movies and farming. Congress eliminated the gimmick by limiting the amount of the tax deduction to the amount actually "at risk"—that is the amount actually paid in or covered by a normal recourse loan.[1]

For some reason, Congress didn't include coal leases and master recordings in the "at risk" limitations, but Internal Revenue is trying to close the coal and master-recording loopholes, among others, by issuing new revenue rulings. If it succeeds, Cal-Am investors may be badly hurt.

Who is Cal-Am? How did it get so big with so questionable a product?

From relative obscurity in 1975, Cal-Am has become, in the words of one tax-shelter specialist who takes no pleasure in saying so, "one of the biggest names presently" in tax shelters nationwide. The company has perhaps the largest network of independent sales contractors in the tax-shelter industry, they number several hundred.

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[1] Except in real estate investments, where nonrecourse mortgage loans are accepted practice.

Legions of prospective salespeople have been flown into Los Angeles, met at the airport by chauffeured limousines and treated to lavish banquets before undergoing a short course in Cal-Am's shelter programs. Listen as William A. Kilpatrick, who runs a Cal-Am-affiliated sales organization, addresses a group of prospective salesmen. "It is not necessary to become a tax expert to sell; the program was put together by experts. You only need know the results for your client. Your product is so good that a trained collie with a note in his mouth should be able to bring back a contract if you don't confuse him.

Born Again: Tax Shelters 1977

MOVIES, EQUIPMENT LEASING, CATTLE, COAL AND ALL THE OTHER FAMILIAR TAX SHELTERS ARE STILL AROUND AND THRIVING, BUT THEY'VE CHANGED. INVESTORS MUST NOW ASSUME NEW RISKS AND GET IN EARLY

When the Tax Reform Act of 1976 became law last October, just about everyone said that, except for real estate, the glory days of the tax shelters were over. After all, shelters were one of the avowed targets of many legislators, who inveighed against the tax tactics of the monied class. But as the months passed and investors got a better look at the situation, it has become clear that tax shelters are alive and well and thriving in America. Just about all of last year's popular shelter programs are being marketed again in 1977, and shelter sales are expected to boom. Vice President Lawrence Winston of E. F. Hutton & Co., Wall Street's top tax-shelter marketers, predicts that sales will increase 25 percent over last year. At Bache Halsey Stuart, tax-shelter sales manager Stephen Blank says that sales of oil and gas programs so far this year are "unbelievable."

To be sure, the Tax Reform Act forced the people who package shelter programs and those who invest in them to modify their techniques, sometimes sharply. In general, the legislation introduced a bigger element of risk into the shelter business and cut the size of the first-year write-offs that investors may claim. The Act hit hardest at the tax benefits investors once got by using nonrecourse loans—that is, mortgages backed only by property for collateral and for which the borrower assumed no other financial responsibility. By using a small amount of cash and a large nonrecourse loan, an investor could buy a share in a movie, farm, oil property or similar shelter and then claim a first-year tax deduction many times his cash outlay. Now, nonrecourse loans are outlawed for most taxshelter partnerships, although individuals still enjoy a few small loopholes.

The tax reformers also chopped away at the deductions an investor may take for the prepayment of certain expenses—for example, feed bills under cattle shelter programs, royalties for coal mines and interest for real-estate construction. Moreover, it whittled write-offs for some items that were expensed by requiring that they be capitalized—on movie production and organization costs, for example. Intangible drilling costs on producing oil wells are now tax-preference items unless they are capitalized. The Act also cut potential returns from shelters. It did this by increasing the minimum tax to 15% and by labeling as ordinary income, instead of capital gains, profits from the sale of oil or gas properties or of other real estate that had enjoyed rapid depreciation.

NEW ECONOMICS

The developers of tax-shelter programs have adjusted to these new requirements, or are in the process of doing so, and thus investors still find them attractive. Another big reason for their continued popularity is the improved economic outlook in many of the traditional shelter areas, which increases the chance that the investment will produce a sizable profit as well as protect income. Oil and gas programs, in particular, are benefiting from high oil prices. Although the odds against finding new oil or gas deposits are still twenty-to-one, petroleum prices have risen much more than the cost of finding new reserves or developing existing pools, thus increasing the profit potential; natural-gas shelter programs are also enhanced by the prospect of some degree of deregulation.

New apartment house syndications are more promising because rental levels are up and vacancy rates are down. Promoters of equipment-leasing programs also have impressive results to tout. IBM 370 computers, for example, have retained a high resale value and have a longer rental life than industry experts had predicted. Owners of 727 and DC-9 jets have reaped huge returns, since these planes have remained in airline fleets much longer than expected and still enjoy impressive resale prices. A used 727 today goes for $4 million, more than the original $3.4 million price when the craft were introduced ten years ago, thus, an investor comes away with a nice capital gain as well as years of depreciation write-offs and rental income. Similarly, railroad freight-car leasing programs have unbroken rental records.

Shelter sales are also being helped because investors are today more confident of getting a fair deal—at least that's what shelter sellers claim. Many—salesmen say most—of the crooks, crazies and incompetents have been driven out of the shelter-packaging field by the recession and by the Securities and Exchange Commission. Wall Street brokers are spending more time and money investigating the deals they sell. In addition, many of the fat commissions, management fees and other charges that skimmed off profits before investors could get them have been eliminated by stricter rules mandated by the government and by self-regulatory bodies.

Finally, notes Laventhol & Horwath, a large national accounting firm, shelter programs continue to thrive for the simple reason that individuals who have large incomes subject to high taxes continue to search for ways to protect that money from the revenue agents.

EARLY BIRDS ONLY

Investors will have to put up their money early this year to get the biggest write-offs. In real estate, for example, the law no longer allows an individual to deduct a full year's costs and other expenses if he buys into a program late in the year—which used to be a common practice. Instead, deductions for depreciation and expenses must be pro-rated over the year. An apartment building partnership that closes out its sale of interest and starts operating on June 30 will get six months' deductions, if it closes on October 31, it gets two months.

As they tailor their offerings to the new law, real-estate shelters are closing deals monthly, assuming they've raised enough money. One syndication that closed the first stage of its program January 31 projects that investors will be able to take a deduction this year equal to 52 percent of their stake. The next stage, which closed February 28, projects a 50 percent write-off. Subsequent stages will yield steadily diminishing writeoffs. Another real-estate shelter, a partnership in a garden-apartment complex, is structured somewhat differently. It calls for investors to put up $70,000 in three stages—$10,000 on April 1, another $40,000 on December 1 and the remaining $20,000 on June 30, 1978. The packagers anticipate that an investor could write off $66,497 for the $50,000 he puts up this year.

Oil- and gas-drilling programs also have a special incentive to get drilling early. The new law provides that the intangible drilling costs for producing wells and for wells that haven't been completed by April 15, 1978 must be treated differently than write-offs for wells that are definitely non-producers. And the law mandates "that all wells are wet until proven dry," says vice president Mary Jane Farmer of Resources Programs, Inc., an oil-program analysis group. The provision is critical. The cost of a dry hole can be expensed in one year. There is an option with unproven wells. They may be capitalized. They may also be expensed, but then any deduction that exceeds what would have been allowed if the well were capitalized becomes a tax-preference item subject to the 15 percent minimum tax. Since write-offs for most oil and gas programs come from intangible drilling costs, the new law means that drillers who are slow in getting wells dug will have few deductions to shelter the 1977 income of their investors.

The change probably won't make much difference to the typical buyer of a $10,000 unit in a public partnership; he'll probably lose only about $100 in deductions. Hardest hit by the change will be the high-bracket investor who puts $100,000 or more into developmental programs—drilling for oil near established wells, a practice that's successful about 80 percent of the time. If he has average luck, he could see his deductions decline twenty percentage points.

NO RISK, NO SHELTER

In equipment-leasing programs, the major change involves the assumption of risk by the person who invests in a tax shelter. Until now, most banks granted nonrecourse loans to investors to help pay for the equipment that was leased out. All the investor had at stake if his program collapsed was the cash he put up; he simply walked away from the loan and allowed the bank ot repossess the equipment. But the law now says that the investor cannot deduct depreciation for the amount of the borrowed money unless he also assumes the risk of repayment. According to President Mark Hungerford of Professional Lease Management, a packager of railcar-equipment leasing programs, the change has not slowed down business at all because railcar buyers willingly sign notes. San Francisco-based PLM expects to double its equipment purchases this year, to more than $12 million, as a result of signing up a new program with a major Wall Street investment banking house.

A number of Wall Street brokerage houses are planning to assemble leasing partnerships in railcars, airplanes and computers. Some of these will provide smaller write-offs than such programs used to offer simply because the packagers will cut the risk by reducing the amount of money borrowed.

In cattle-feeding deals, the investor who wants a substantial write-off must also personally sign for the amount of money he borrows to pay for the steers and feed. Western Trio Cattle Co., the leading public partnership in cattle feeding, offers a new program this year that will give investors a 130 percent write-off. To get it, the investor must sign a note for an amount equal to 30 percent of his own cash outlay, and he must buy into the program before August 1. (He can get a 150 percent write-off by investing by June 1.) His risk of having to come up with cash to pay off the note is minimal, since the bank has the first call on revenues from the sale of the fattened steers.

An individual investor who goes into cattle feeding on a one-on-one basis rather than a partnership has more flexibility. He can arrange with a feedlot operator to manage his cattle for him for a fee. By doing so, he might be allowed to deduct expenses for prepayment of feed costs, even though the law struck out such a practice for investors. The potential loophole is that the individual might be considered a farmer, with no control over the buying practices of the feedlot, and not just an investor seeking a tax-avoidance device. For a fee, many tax accountants, attorneys, banks and brokers will locate feedlots that will deal with individual investors.

Tax-shelter advisers are also confident that coal deals will be packaged this year, although they aren't sure exactly what form they will take. They're optimistic because of the favorable economic outlook for the fuel. Aside from the tax write-offs, the best thing about coal deals is the highly predictable cash flow. In a typical arrangement under the old tax laws, an investor group contracted with a small mine operator to buy his output at a fixed price. They paid the operator five years' royalties in advance, using a small amount of their own cash and the proceeds of a loan backed by the coal reserves. The operator not only managed the mine, but he also found customers and contracted to supply them at a fixed price well above the cost to the investor group. During the first year, the prepaid royalties allowed investors to deduct from income two-and-a-half times their cash stake, and the arrangement typically provided a reliable 15 percent return.

Now that the five-year prepayment of royalties has been struck down, coal shelter packages are likely to include some leasing of coal-mining equipment, some exploration for new coal-reserves to produce write-offs and some mining of existing coal on a royalty basis to produce cash flow, E. F. Hutton's Winston believes. The first-year deduction will drop sharply and the probable annual return would be 10 percent or so.

The big risk in coal investment is that the engineering estimates of coal reserves may be overly optimistic. Shelter experts advise any coal investor to employ an independent geologist to check on the coal operators' estimate—and even this independent estimate is no guarantee of accuracy. Furthermore, coal investments may be endangered by strikes, floods and mining accidents.

Movie tax shelters must also be dramatically restructured because of the new rules on nonrecourse loans and the expensing of production costs. A few large Wall Street houses are now considering the sale of a new tax-deferral scheme based on a movie distribution, not production. According to a prospectus filed with the SEC by Integrated Resources, Inc., an Amex-listed marketer of real-estate syndications, partners in the plan will joint venture with an established distributor and share the films' revenues from movie theaters, television and airlines. The investors will pay for the manufacture of the movie prints and for promotion and advertising. A moderately successful movie can use 300 prints worldwide, with the average 35 mm print costing between $600 and $900.

CELLULOID SAVINGS

The syndication will probably require a minimum investment of $5,000 and anticipates a first year write-off of roughly 85 percent of the investment. The tax write-off comes from a number of sources: the investment tax credit for the prints, depreciation and advertising expenses. The partnerships will produce tax deferrals for three years or more by reinvesting the proceeds in the early years.

Distributing movies is less risky than producing them, but there is still plenty to worry about. Rental income depends on audience appeal, and prints and advertising expenses can multiply without any guarantee that the picture won't bomb at the box office. An investor's profits depend on collecting his share of rental revenues after expenses, and that is decidedly chancy because distributors and movie-house exhibitors often practice business with artistic license. For one thing, every link in the theatrical distribution chain is slow-paying. Then, too, a distributor may contract to handle a film and then lose interest in the project and neglect it, despite the contract. The partners have no practical recourse. One advantage the distributor-investor generally has is first call on rental revenues until the cost of prints and advertising are recovered.

Records are another tax shelter for investors who like movie deals. A number of record partnerships were syndicated privately, last year, but partnerships as shelter mechanisms are no longer stable. But the methods used are feasible for individual investors, who would then satisfy the provisions of the new tax law. In a record deal, the investor buys a master recording, with a 10 percent cash down payment and the balance in a nonrecourse note that allows the record distributor or producer to repossess the master for nonpayment. Since the investor is depreciating the full value of the master, including his huge note, he could easily write off more than his first year's cash outlay. Furthermore, he also can deduct other expenses and take the investment tax credit.

Most record deals offered last year were for recordings of new pop artists and not top names. And except for Warner Communications and Columbia Records, practically every well-known record company making contemporary music was involved in record shelters. For example, one investor bought himself an interest in the yet-to-be-released record of a brand-new rock group, the Brass Ball Band, whose output will be distributed under the Motown label, one of the top-selling companies. The investor put up $40,000 and borrowed $125,000 for three master album recordings. The investor who claims shares in a number of oil and gas partnerships, an orange grove and a cable television station, said he went into records because "I wanted to diversify."

He is venturing into a very dicey business. According to *Billboard* magazine, the record industry trade journal, 3,500 records—singles and albums—were released in 1976. Of these, 204 were gold records—thatis, a single record selling 1 million copies or an album selling 500,000 copies. So the chance of making a killing was roughly seventeen-to-one. According to Roger Smith of Warner Communications, most records would have to sell 100,000 copies to break even. He estimates that last year 600 records sold between 150,000 and 200,000 copies, and probably were profitable. The Cambridge Research Institute studied record industry profitability in 1972 and found that 77 percent of all popular records and 95 percent of all classical releases that year failed to turn a profit.

Nor is this surprising considering the large number of people who share in the revenues. The record company receives $3.50 for an album that lists for $6.98 at retail. With its $3.50, it must pay 70 cents to the artist, 20 cents to the songwriters (2 cents for each cut, and there are usually ten cuts to an album), 40 cents for production costs, 15 cents for the jacket, 50 cents for distribution and promotion, 30 cents for advertising and a tour support of the artist and 10 cents for a contribution to the American Federation of Musicians fund. This leaves a gross profit of $1.15.

Profitability may also be slashed by returns, which run about 20 percent of shipments. These usually are sold at reduced prices over a period of years in the so-called "schlock market," perhaps bringing the producer 60 cents a record.

Obviously, the unknown tax consequences and economic hazards of putting money into any of the new or restructured tax deals are large. The proposed new record deals, for example, are being carefully scrutinized by the Internal Revenue Service. As tax-shelter adviser David Gracer said aboult movie deals years ago: "Investors should consider themselves pioneers—and, like all other pioneers, not be surprised if they are attacked by Indians." Still, new tax shelters will continue to take shape as long as taxpayers with large resources will buy them. And it appears as if the tax shelter business is imaginative enough to survive.

GIMME SHELTER

THE TAX REFORM ACT KILLED THE TAX-SHELTER GAME, RIGHT? WRONG. THE BUSINESS IS YEASTIER THAN EVER, AND JUST ABOUT AS TRICKY

(By Harold Seneker)

An uninformed visitor to John Loughlin's office might think he had wandered into the chairman's office by mistake. His space at Merrill Lynch, Pierce, Fenner & Smith is large. The view is panoramic. The carpet is thick. The freestanding desk is dark, polished wood, elegantly paneled, its surface uncluttered by even a single sheet of paper. Loughlin's manner is cultivated, smooth and relaxed, and he is very persuasive. "Merrill Lynch studied this business for years and years before getting into it in 1972," he tells a visitor. "And now we proceed very carefully, and cautiously."

Tax shelter is Loughlin's game, and the intimation of established wealth and caution he and his office exude have a purpose: The unwary affluent have been taken for many millions of dollars, often legally, in this business. Loughlin's demeanor says: There's none of that here.

Tax shelters are booming again, in good part because inflation, prosperity and our progressive tax laws keep pushing more and more people into brackets where paying really hurts. Given Merrill Lynch's fine reputation, it appealed to customers who wouldn't trust an ordinary tax-shelter deal. "In 1975 we attracted $53 million in (tax shelter) equity investments," Loughlin says, leaning back in ~~his~~ chair. "Last year, $77 million; this year we expect to do over $100 million."

Merril Lynch is by no means alone. Today nearly every retail brokerage house in the country has discovered the potential of tax shelters as a new source of business.

Sales commissions run from 6 percent to 8.5 percent of the money invested, the kind of return that energized all those mutual fund salesmen back in the sixties and fifties.

Last year tax shelters attracted at least $2.4 billion. About $1.2 billion of that was in public placements registered with the Securities & Exchange Commission or with state agencies. The other half (or more) is in private placements, which are limited to 35 or fewer investors and which do not have to register with the SEC. Private placements are the province of not only the brokers, but a whole army of lawyers, accountants and promoters—some sharp, some of them just sharks.

This year's take in tax shelters—public and private—could be higher still. The industry's rule of thumb is that anyone who has part of his income in the federal 50 percent bracket is a prospect. Published Internal Revenue Service data for 1973 (the latest figures) showed 568,849 taxpayers at the 50 percent level or higher that year. That's a lot of potential business. Since then, many more thousands of rock singers, TV personalities, doctors, airline pilots, lawyers and assorted executives have joined the top brackets.

Last year's reforms reduced but by no means eliminated their opportunities for shelter. Many of the more absurd deals (deduct three times your investment the first year, and the like) have been squelched, but worthwhile shelters remain (and many new absurdities are, naturally, being hatched). "Nearly all of our volume is in real estate tax shelters, and in oil-gas-drilling ventures," says Loughlin.

Real estate was relatively lightly touched by the Reform Act, and government-subsidized housing for the poor and elderly hardly at all. And the potential, if always unpredictable, returns on drilling ventures are now such that allowable writeoffs make them a good businessman's risk.

How can you tell a fair drilling deal from a bad deal?

Victor Alhadeff, the 31-year-old founder and chairman of ENI Corp., perhaps the country's leading factor in financing independent oil and gas drillers, has some rules of thumb. It is rational, he figures, for a conservative investor (developmental drilling, as opposed to wildcatting) to shoot for: cash flow beginning in

12-plus months; his original investment back in four years or so (not counting tax benefits); and a cash return of 2 to 1 on his investment over the normal ten-year economic life of the producing wells. None of this is guaranteed, mind you—each well is a gamble—but it is a reasonable goal. (As for exploratory drilling, Alhadeff makes it clear that's strictly a crap shoot.)

Then comes the tax benefit: deductions in the first year equal to 70 percent to 80 percent of the cash investment, with the rest of it written off in the second (and perhaps third) year. There is also partial shelter for the income from the wells, provided by the depletion allowance.

Switching to real estate deals, the brokers' offers generally fall into two categories. One is pooled investments in existing commerical and apartment buildings. These are basically conventional real estate investments, normally favored under tax law, cut up into conveniently sized units of a few thousand dollars each. They shelter little or none of the investor's other income, but do provide a tax-free cash flow and/or prospective capital gains.

The other is subsidized housing. "There's been a pickup in the last four or five months," Loughlin says, and produces a sheet of paper outlining one such deal. In it, a theoretical investor puts in $60,000 in five annual installments. In each of those years, his tax deductions run from 1.5 to 1.9 times the year's installment. Deductions continue, in amounts declining steadily toward zero, for a full 20 years. Total deductions over two decades: $178,900. "But there are risks," he concedes. "You cannot sell for 15 to 20 years. If the buildings deteriorate and have to be abandoned in that time, the tax law's recapture provisions kick in, and you get presented with a big tax bill for some or all of those early deductions. Moreover, the cash return is limited by the government to 6 percent, but rarely, if ever, gets that high; we project 1.5 percent to 3 percent." In other words, the real payoff is in the tax offsets, not in the deal itself.

Ah yes! There are plenty of drawbacks to tax shelters! Stephen Blank, 31, of Bache, Halsey Stuart has the same job as Loughlin's: running his firm's tax-shelter operation. Where Loughlin mostly sounds a "conservatism" theme, Blank is more direct about discussing risk.

"Too many people see only the tax loss and not the dangers," he says between phone calls. "When we first started, we found we had trouble reminding salesmen enough times that shelters pass the risks through to the investors along with the benefits."

The brutal fact is that people have been burned in the past in tax shelters—and will be again. The very best ones are often kept by insiders and are rarely available to the general public. On top of this, limited partnerships—the structure given nearly all tax shelters—are wide open to potential abuse, and often rife with build-in conflicts of interest. The limited partners—that is, the public—do not run the business. The general partner, who has the unlimited liability and presumably the expertise, does that his way. And he may well have little of his own funds invested in the venture.

Knowledgeable people, like ex-commissioner of the IRS Sheldon Cohen, have come to develop very jaundiced views. "When you say 'tax shelter,' your average doctor or lawyer doesn't really look at the deal," claims Cohen. "He just wants to know what the tax saving is. If it's big, he says, 'Where do I line up?' That's why I expect an awful lot of crap to be offered again this year—just like every year."

Tucked away in the relative fastness of Johnstown, Pa., William G. Brennan, 34, studies the offerings with a hard eye. He publishes a wideranging, knowledgeable newsletter devoted to analyzing tax law and tax shelters of every description. Inundated by prospectuses and offering memoranda, Brennan has some rules for judging tax shelters.

The first (and sometimes the last) is simply an X ray of the promoter's reputation. If you have connections with a major accounting firm, it can often provide references for you with a single telephone call to its local office.

"Also, see what company the promoter keeps," says Brennan. "Who does his accounting? If reputable brokers offer the deal, that is a good sign because they have to do some checking on their own.

"Then you look at the promoter's track record in other deals. He must disclose it in public offerings; if he's making a private offering, find out anyway.

"You also want to know the general partner's net worth, so you can compare its financial strength with all the commitments and contingent liabilities it faces. If you discover a shell corporation when you look, or can't determine net worth, watch out.

"Sales commissions shouldn't have to be much over 8 or 8.5 percent (very rarely 10 percent). If they're hidden, or if someone tells you there is no commission, run. There has to be a commission somewhere—you're almost never dealing with the principal. If they're hiding that, they're hiding other things."

Then Brennan goes over a few of the legal ripoffs.

"Make sure you can't be hit for involuntary assessments—finding additional funds at need should be the general partner's responsibility. And look at the fees. Especially the fees and expenses he bills at the front end, before any fixed investments are made. The front-end load shouldn't exceed 20 percent, including sales commissions—or about 10 percent in equipment-leasing deals, which are very cheap to set up.

The Art World Turns to Original Prints as Tax Shelters

(By Grace Glueck)

The flower etching by the well-known artist Lowell Nesbitt was beautiful, the affluent investor thought. And the plate from which it had been made, plus the rights to everything produced from the plate, was for sale for $234,000, with only $44,000 cash on the line.

The investor was told he could profit from the sale of prints, posters and other items made from the plate. But even more attractive was the income tax write-off. Because the plate was a "depreciable property" with a "useful life" of seven years or more, he'd get an investment tax credit for the first year of his ownership, and could deduct for the plate's depreciation over a long period. The write-off in the first two years alone would be $64,400. He plunked down the initial payment and signed a 10-year note for the rest. And so he was in the business of producing artists' prints.

The transaction is typical of a trendy but controversial new development in the art world—the use of original print editions as tax shelters. With changes in the 1976 tax law discouraging shelters in such fields as motion pictures, agriculture, oil wells and equipment leasing, a number—200 to 300 as a "guesstimate"—have already turned to the lucrative field of art.

Another concern of those who dislike the shelter plans is that the market may be flooded with prints. Sylvan Cole, Jr., a member of the dealers' association and head of Associated American Artists, one of the country's largest print galleries, says that the tax shelters will "create huge print editions, sold at inflated prices." "They may glut the market and drive prices down drastically," he added.

Though some artists spurn the shelter proposals that would involve them in the market because of the plans' blatant commerciality, others have turned to a different kind of shelter arrangement that will, they hope, end up placing their work in museums. As detailed by at least one entrepreneur, the plan involves the commissioning of top drawer artists with established market prices to do print editions.

The prints are sold, at "wholesale" prices, to taxpayers who hold them for several years, then donate them to museums at an "appreciated" value.

Two Tax Shelters New Favorites of Enthusiasts

JOHNSTOWN, PA., June 11 (UP)—Tax shelter enthusiasts have come up with two new schemes—involving timber cultivation and horse breeding, according to William G. Brennan, Inc., the Johnstown tax shelter expert.

Brennan said he had few details on the timber tax shelter schemes except that they appeared to parallel the coal mining tax shelters punctured by the Internal Revenue Service last year. He said none of the plans actually appeared to have been brought to market as yet.

The coal mining tax shelters foundered when the Internal Revenue Service outlawed non-recourse loan financing and allowed tax deductions only for sums that were invested "at risk."

Brennan said the horse breeding tax shelter plans involved investments in breeding both race horses and show horses. He said some of the schemes were proposing tax writeoffs of 248 percent of the investment in the first year, which would provide a very substantial tax shelter for other income.

But Brennan said these claims should be viewed with great skepticism. Considering the way the plans are structured, he said, the investor is liable to find himself still owing 95 percent of the debt at the end of five years. By that time, he said, the chances of the horses still being worth the face amount of the investment are problematic.

Mr. BRANDON. Finally, let me just make a quick observation on tax expenditures. There was a great deal of discussion earlier on tax expenditures. While the talk here is that somehow the tax expenditure approach begins with the assumption that the Government owns all of your money, this is not the case. The term "tax expenditures" refers to benefits granted to favored individuals and businesses in the form of reductions in the taxes they would otherwise owe.

We would rather see—and we have supported—broad reductions across-the-board.

Those who argue that tax expenditure analysis begins with the premise that all income belongs to the Government must logically conclude that wages are somehow more the Government's money than income from oil or exporting or capital investment and the like. I find that inconsistent.

I think if you are talking about the Government taking too much of people's money, taxes should be reduced, and we would recommend that taxes be reduced. We think they should be reduced across-the-board rather than trying to target specific interest areas for specialized treatment.

Senator BENTSEN. Thank you very much.

Senator Packwood?

Senator PACKWOOD. Mr. Brandon, your statement reiterates anti-rich statements but they are made just on the bald basis, if the rich get a break, it is bad. There is no trade-off. It is just that per se.

You do not have to comment on that. Every page has that.

Let's go to the Hansen-Steiger bill to begin with. If, for no other reason—and there are many others—why not pass it simply because it would result in an increase in revenue to the Treasury?

Mr. BRANDON. I am not interested in simply increasing revenue to the Treasury. I would like to see that the goods and services supported by the Federal Government are paid for in a fair and equitable manner, and I do not believe——

Senator PACKWOOD. Can we not pay for more of them if we pass a bill?

Mr. BRANDON. Again, regardless of what level of expenditures you want to talk about, I think that they have to be borne fairly by all American taxpayers. I think the Steiger-Hansen proposal strikes at the very heart of that concept by taking very wealthy individuals entirely off the tax rolls in some instances. I mentioned in my testimony that I do not see how Members of Congress could vote for giving 3,000 people whose annual incomes are over $1 million a year reductions of $214,000 apiece.

Senator PACKWOOD. You think it is better that they remain on the tax roll. I even quarrel with your conclusions on this.

Do you think it is better that they be on the payroll and we have a reduction in Government revenue, than to take them off of the tax rolls and have an increase in Government revenue?

Mr. BRANDON. At some point, we can reduce everybody's taxes and, I think, stimulate the economy in a much more efficient manner.

I see nothing in the Steiger-Hansen proposal that goes to stimulating the economy in a way that is better than five or six other kinds of proposals—for instance, cuts in the corporate rate, the investment tax credit, general tax reductions for individuals, et cetera.

I think that repealing the minimum tax on capital gains is one of the least efficient ways of stimulating the economy.

Senator PACKWOOD. I want to come back to my question. I am not talking about stimulating the economy. It may or may not; I think it will.

But with the assumption of the Treasury, who admits that their assumptions are static and assume no change in behavior, everybody, including Professor Eisner, says yes, we will realize more money, at least, if we pass the Hansen-Steiger bill. He says that, even though he does not like the Hansen-Steiger bill.

I sense, though, that what you are saying is you would rather not have it. You would rather have us reduce Government revenue than to have some of the rich escape taxation.

Mr. BRANDON. Again, I would rather have whatever level of revenue there is to be borne fairly by all taxpayers. I think that is the basic notion of our tax system.

Senator PACKWOOD. Let me ask you about Art Pine's story in the Post—the rich in the United States are paying 94 percent of the income taxes. Households earning over $10,000, 48 percent of the households, they receive 81 percent of the income and they pay 94 percent of the taxes.

The Tax Foundation found that those in the 50-percent bracket paid 89 percent of the tax.

All of the tax reductions and tax reform bills since 1969 have reduced the rate on the lower half and increased it on the upper half so the upper half is paying more taxes.

How far do we go? How much should the upper half pay?

Mr. BRANDON. Let me say I do not think that is correct, that all of the tax bills have reduced taxes on the lower half and raised them on the upper half.

Let me also say that all that story really reflects is that we have a progressive income tax system. It leaves off the 20 percent of the families in the country who are below the poverty line from whom we do do not expect to get income taxes, and as I say, it is simply a statement that income taxes are borne in a progressive manned. The top half of all taxpayers do pay 90-some percent of the income taxes, but they also have over 85 percent of the income. Individuals in bottom 48 percent, who pays 6 percent of the income taxes, have average incomes of less than $4,500 apiece.

We would recommend, as we did in the House, larger tax reductions for individuals making less than $50,000 per year. Those account for 98 percent of all taxpayers. I do not think that is putting a greater and greater burden on the upper 50 percent.

Senator PACKWOOD. I am looking again. Those who make under $10,000, including people who make nothing, pay 6 percent of the income taxes in the country. It is obvious that at least, if these statistics are right in the last 7 years, we have moved toward more progressivity in the income tax in one form or another, either by eliminating people at the bottom or increasing the rates at the top, because the top are now paying more and more.

All I am saying is, how far do you want to go? Where is fair?

Mr. BRANDON. I agree with you that the progressivity has increased somewhat, particularly on the $200,000 and over class, as a result of the 1976 Tax Reform Act. When you look at the effective tax rates, they paid about 34½ percent before that act, 37 percent now. I do not think that is grossly unfair, to ask those individuals to pay 37 percent.

Let me focus particularly on the capital gains situation, which you mentioned. We are not talking about tax rates of even 37 percent when we talk about capital gains effective tax rates. For a $200,000 individual with all his or her income in capital gains, we are talking about a tax rate of about 19 percent.

And the proposal by Senator Hansen and Representative Steiger would reduce the effective tax rate on this individual to about 12 percent. I would ask, How far do we go in the other direction of reducing the rates on the very high-income people?

Again, it is a matter of choice, obviously. We disagree, and I believe the majority of the American people—certainly those 98 percent who would get a reduction under what we are talking about—woud agree with my position.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Senator.

Senator Roth?

Senator ROTH. If I understand your testimony, you do favor some sort of substantial individual tax cut. The President, in some statements, said that we ought to reduce the personal income tax roughly to 50 percent on the high side, 10 on the low. The Roth-Kemp goes a little further on the low side—we would go as low as 8 percent.

I would also point out, in the Roth-Kemp legislation, we actually increased progressivity, as pointed out by the Library of Congress study on the low end. It goes as high as 80 percent because of some of the peculiarities of the tax laws. At the 15 percent tax bracket, the cut is roughly 40 percent.

Would you support that kind of tax cut, the goal of reaching 50 percent on the high side, 8 to 10 percent on the low side.

Mr. BRANDON. I would. I would probably go further if we are talking about actual tax rates, and not simply nominal tax rates. I think there is the real problem.

You can have a tax schedule that goes up to 50 percent, but some of those individuals in the 50 percent bracket would be paying nothing. If we extended the base, we could reduce taxes across-the-board substantially, and I would support that wholeheartedly.

Senator ROTH. One of my concerns on the low end of the economic scale, because of the problems of inflation, which were pointed out in your statement, we need to have a beneficial effect on the economy by giving the more affluent some more incentive to work and save. That is one of the reasons I think it should be a goal of our tax proposals that we basically reduce the rates at the high end to roughly 50 percent.

You can argue the point.

One question, you can have two goals, it seems to me, in your tax approach. One is what is fair and what is equitable. In a sense, that is pretty hard to evaluate. It sort of depends on the size of the chancellor's foot.

But it does seem to me, in many ways, that our key goal, our key objective now, should be to try to get some buoyancy in the economy. One of my concerns is not really a question—we should not be so concerned with income transfer, but with trying to get some spark into the economy, to perhaps create a little larger pie that those on the lower economic scale can share.

Do you have any comments? What should be our principal goal?

We could go the route and say, there are loopholes. We are all aware of that. One of my concerns, whatever you do, there are always some smart tax lawyers and smart people around to find ways of using it to their own advantage.

A few bad examples do not necessarily make good law.

But would you agree that our principal concern today ought to be having the economy move upward, or should we be more concerned?

Mr. BRANDON. One principal concern has to be moving the economy upward. I do not think the goals are inconsistent at all.

If we are really talking about shifting income to the private sector away from the public sector, all I am saying is that that can be done in a much fairer and more equitable manner.

The level, again, at which the tax burden is placed has not changed significantly as a percentage of GNP. Investment has not changed significantly as a percentage of GNP, and I think it is somewhat dangerous to compare our situation with those of the economies of particularly West Germany and Japan.

Our productivity over the last three decades or so would be substantially greater, our investment as a percentage of GNP would be substantially greater, if we had been bombed and destroyed substantially during the Second World War. I think that is the important part that people leave out when they make those comparisons.

I would also just mention, as an example of stimulating the economy, that the unfortunate slide in the value of the dollar that has occurred recently has had a great deal more effect, I think, on the relative price of exports and therefore has stimulated exports than anything that DISC could ever do.

I think DISC is an example of one of those worthless subsidies. If we would just reduce rates instead of having DISC, we would have a much more rational investment policy, and a much more stimulated economy.

Senator ROTH. If I just may have 30 seconds, Mr. Chairman, I would think that most people would agree that the state of our economic health is bad today, that something has to be done to try to get it moving in the right direction, which I think we can do by properly tailored tax cuts.

While the slide of the dollar, in theory, is supposed to help with sales abroad, the facts show it has not yet had the beneficial effect that the economists or theorists would expect.

Mr. BRANDON. I am not suggesting it is good.

Senator ROTH. For example, in the case of Japan, who imports all of her oil, she is also able to buy raw material at a cheaper price because of the yen's going up, so there are offsetting factors that make the theory not work too well in practice.

Thank you very much.

Senator BENTSEN. Mr. Brandon, your comment about comparing Germany and Japan to this country, and using the period of time since World War II, I think that is the salient point all right. But if you take the last 5 years, the war has been over now for 30 years, and in the last 5 years we have continued to decline in productivity, and at some point, that just has to turn around.

And therefore, I believe that we do have to have the incentives for investment capital in this country.

My concern, too, is for the entrepreneurial approach. One of the reasons that I think we need something done on capital gains is because of that, and I recognize it all does not go on the stock market, and in fact, not over a third of it. But I do not think you can equate all sources of income. I think you have to give some recognition for this.

This is an imperfect way to recognize it, I understand that, but these people who have wealth do not have to go into risk situations and unless they see a reasonable rate of return and new ventures, new companies generally fail—the vast majority of them do—they are just not going to do it. They are going to put those investments in more stable, more certain returns.

So that is my concern. How do you respond to that?

Mr. BRANDON. I think there is something that can be done in the venture capital area, and I think what you say is right that the capital gains approach is an imperfect way of doing it. In fact, I would suggest that it is a terribly imperfect way of doing it.

There were proposals in the House to provide for special treatment for venture capital types of situations. Again, I am not sure using the tax system is the proper way to do that, because I think it is very difficult to target what is an actual risk situation in that.

And I would be reluctant to encourage a great deal of investment willy-nilly in one area that could be more productive in the area of housing, or something like that that we know are needed.

There are other programs, obviously, that could support beginning businesses. The Small Business Administration has a number of small programs.

I do not know the precise answer to the problem. I know it is not simply repealing the minimum tax on capital gains or increasing the exclusion across-the-board for all capital gains.

Senator BENTSEN. I have not found a tax system yet that is totally fair. I doubt if we ever will.

Are there any further questions?

Thank you very much for your testimony.

Mr. BRANDON. Thank you, Senator.

[The prepared statement of Mr. Brandon follows:]

STATEMENT OF ROBERT M. BRANDON AND ROBERT S. MCINTYRE OF PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP

SUMMARY OF PRINCIPAL POINTS

The House-passed tax bill is an affront to the tax system and to the vast majority of American taxpayers. President Carter presented Congress with a tax

reform and reduction bill that would have substantially improved the fairness of the tax laws and at the same time have provided real tax cuts for almost everyone. The House has responded with a bill which provides real reductions for only a few, high income individuals and actually makes the tax system substantially less fair.

We urge the Finance Committee to make the following changes in the House-passed bill:

1. The overall tax cuts should be restructured to give gretaer relief to taxpayers making under $50,000, and especially to those in the under $15,000 income class, where inflation has eaten away at the ability to purchase even necessities.

2. The capital gains tax reductions in the House bill should be scrapped. If a lower maximum possible rate on capital gains is sought, the top rate can easily be reduced to 39 percent by eliminating the "poisoning" of the maximum tax on earned income. Going to a lower top rate involves tampering with the minimum tax or increasing the capital gains exclusion, both of which we strongly oppose. However, if the Committee does accept the House proposal to repeal the existing minimum tax on capital gains, it should adopt the Fisher-Corman alternative minimum tax as a substitute, rather than the House-passed "micro-mini" tax.

3. The few reforms passed by the House should be preserved, and the Committee should also include measures to cut down on expense account living deductions and deny tax breaks to discriminatory health and life insurance plans. The Committee should adopt provisions repealing the tax exemption for pollution control bonds and eliminating the five-year amortization allowance for anti-pollution devices. The administration proposal to tie increasing the small issue limit on industrial development bonds to restrictions on the use of such bonds should be adopted. Also, the House-passed "chicken amendment" should be deleted, and the administration proposal in this area adopted instead.

4. The Committee should consider approving the taxable bond option and withholding on interest and dividends.

DISTRIBUTION OF THE OVERALL TAX CUTS

Because of inflation and social security hikes, taxes as a percentage of individual incomes will rise substantially in 1979 in the absence of a tax cut. Inflation alone (if the rate levels off to 1 percent will add 9/10ths of a percentage point to the overall effective tax rate, and payroll tax increases will mean an additional 4/10ths of a point. We believe that the distribution of the tax cuts should be designed to offset these increases as fairly as is possible within budgetary constraints. As the chart shows, the House-passed bill fails to achieve this goal. In fact, the only income class whose members are fully protected against inflation and payroll tax hikes is the over $50,000 category, and the only group which gets an actual rate reduction is the over $100,000 income class:

1978 expanded income class	1979 changes in effective tax rates due to inflation and social security hikes (i.e., tax increases as a percentage of real income) without a tax cut	H.R. 13511's reduction in effective tax rates (percent)	Net change in tax rates in 1979 (percent)
Less than $10,000	0.9	0.2	+0.7
$10,000 to $20,000	.8	.5	+.2
$20,000 to $30,000	1.9	1.0	+.9
$30,000 to $50,000	1.8	1.2	+.6
$50,000 to $100,000	1.5	1.5	0
$100,000 to $200,000	1.1	1.3	-.2
$200,000 and over	.4	1.9	-1.5
Total	1.3	.9	+.4

Because of inflationary pressures, it is probably impossible to institute a tax cut large enough to protect all taxpayers from inflation and increased payroll taxes. We believe, however, that a much fairer cut can be designed. For example, the Fisher-Corman substitute which the House rejected was a far more equitable solution. It offered almost full protection to taxpayers earning under $20,000 (three-quarters of all returns), and gave substantially more relief to taxpayers in the $20,000-50,000 range:

[In percent]

1978 expanded income class	1979 tax rate increases without a tax cut	Fisher-Corman reduction in effective tax rates	Net change in tax rates in 1979
Less than $10,000	0.9	0.9	+0.1
$10,000 to $20,000	.8	.9	-.1
$20,000 to $30,000	1.9	1.1	+.8
$30,000 to $50,000	1.8	1.4	+.4
$50,000 to $100,000	1.5	1.1	+.4
$100,000 to $200,000	1.1	.8	+.3
$200,000 and over	.4	1.0	-.6
Total	1.3	1.0	+.3

It is especially important for the tax cuts to protect moderate and average income taxpayers for whom inflation reduces the ability to purchase the basic necessities of life. In addition, the tax cuts should also attempt to provide relief to middle class taxpayers who will bear the brunt of last year's payroll tax hikes. The base hikes enacted last year were designed to fulfill the increased needs of the social security system in the fairest way possible, and that they do. But in the short term, the hikes also create a "tax shock" in the middle and upper-middle brackets, making some relief appropriate. As the chart shows, it is in the $20,000-50,000 range where the payroll tax hikes are most severe:

EFFECTIVE PAYROLL TAX RATES, 1978 AND 1979, AS A PERCENTAGE OF TOTAL INCOME

1978 expanded income class	Average 1978 rate	Average 1979 rate	Change in rate
Less than $10,000	6.05	6.13	+0.1
$50,000 to $20,000	6.05	6.13	+.1
$20,000 to $30,000	4.41	5.40	+1.0
$30,000 to $50,000	2.91	3.57	+.6
$50,000 to $100,000	1.62	1.98	+.4
$100,000 to $200,000	.80	.98	+.2
$200,000 and over	.23	.28	+.05
Total	4.45	4.87	+.4

Although H.R. 13511 has been styled in the media as a "middle class tax cut," it is most emphatically not that. Only taxpayers earning over $50,000 per year—the top 2 percent of all taxpayers—do better under the House bill than under the Fisher-Corman substitute which the House rejected. Even under the most expensive definition of "middle class," H.R. 13511—whose tax cut distribution was supported by virtually all the House Republicans but by only a third of the Democrats—can unmistakably be classified as a bill for the very wealthy.

We believe that it is incumbent on the Finance Committee and the Senate to amend the House-passed tax cut to provide real relief to average and middle class Americans. As it now stands, H.R. 13511 is nothing but a cruel hoax on 98 percent of the nation's taxpayers.

CAPITAL GAINS

We strongly oppose the efforts to expand further the capital gains loophole. The various tax preferences for income characterized as "capital gains" already cost the Treasury over $17 billion annually—almost $200 for each and every individual who files a tax return. In fact, the total taxes assessed on capital gains income are less than a third what would be collected if capital gains were treated the same as other income. We believe that this tax expenditure should be reduced, not enlarged.

Equity problems

The leading proposals to cut capital gains taxes even further are particularly offensive because their centerpiece is repeal of the minimum tax on sheltered gains. This means that the lion's share of the benefits will go to high-income individuals otherwise paying little or no regular taxes. Under the Hansen-Steiger bill, for example, three thousand people earning over $1 million a year would get tax reductions averaging an incredible $214,000 apiece. In fact, this small group of investors would share 40 percent of the total Hansen-Steiger capital gains tax reductions.

EFFECTS OF THE STEIGER-HANSEN BILL ON INDIVIDUALS WITH NET CAPITAL GAINS

[1978 income levels]

Expanded income (thousands)	Number of returns with capital gains (thousands)	Percent of total $45,400,000,000 in capital gains	Average gains per recipient	Number of returns benefiting from Steiger (thousands)	Percentage of returns with capital gains benefiting from Steiger [1]	Average benefit per return with gains
Less than $15	1,949	12.1	$2,814	3	0.2	$3
$15 to $20	752	6.1	3,673	11	1.4	4
$20 to $30	1,124	10.1	4,078	30	2.6	12
$30 to $50	957	14.4	6,812	99	10.3	69
$50 to $100	468	17.0	16,054	131	27.9	483
$100 to $200	136	11.1	37,110	76	56.0	1,752
$200 and over	46	29.2	288,087	34	74.1	23,963
Total	5,540	100	8,325	383	7.0	303

[1] Col. 5 divided by col. 2.

Source: Data from the Joint Committee on Taxation and the U.S. Department of the Treasury. Arithmetic calculations by Public Citizen's Tax Reform Research Group, July 16, 1978.

CAPITAL GAINS TAX CUTS UNDER H.R. 13511 (NOT INCLUDING RESIDENCES OR BASIS ADJUSTMENT)

[1978 income levels]

Expanded income (thousands)	Number of returns with capital gains (thousands)	Number of returns benefiting from H.R. 13511 (thousands)	Percentage of returns with capital gains with tax cuts	Average net cut per return with capital gains	Percentage distribution of net cuts
Less than $30	3,825	41	1.1	[1] $-6	[1] -2
$30 to $50	957	99	10.3	59	6
$50 to $100	468	124	26.5	412	20
$100 to $200	136	43	31.6	1,125	16
$200 and over	46	22	47.8	12,418	60
Total	5,540	327	5.9	112	100

[1] Taxpayers in the under $30,000 income class would pay $23,000,000 in additional taxes under H.R. 13511's basic capital gains changes.

Source: Data from the Joint Committee on Taxation and the U.S. Department of the Treasury. Arithmetic calculations by Public Citizen's Tax Reform Research Group, Aug. 15, 1978.

While the Hansen-Steiger proposal targets close to $60,000 apiece to some 15–20,000 individuals earning over $200,000, it gives nothing at all to 99.6 percent of all taxpayers. Over 80 percent of its benefits would go to individuals earning more than $100,000 per year, and most of the beneficiaries would be high income people who have lots of other shelters in addition to lots of capital gains. For example, a person with $100,000 in salary, $40,000 in capital gains, and no other tax shelters currently pays no minimum tax—and would get nothing from Hansen-Steiger.

The Hansen-Steiger bill would take 110 individuals with incomes exceeding $200,000 each entirely off the tax rolls—giving each an average tax reduction of $77,000. This would be more than triple the number of such high income people who pay nothing.

On the corporate side, a few large timber corporations stand to gain the very most from the Hansen-Steiger bill. They already garner the lion's share of a $230 million tax subsidy which lets lumber corporations treat over half their ordinary profits as capital gains—a giveaway in some cases surpassing even the now-largely-repealed percentage depletion allowance for oil and gas. In fact, as noted in a 1972 Joint Economic Committee paper, the very biggest timber companies "are able to shift nearly *all* their income into the lightly taxed capital gains category." By lowering the corporate capital gains rate to only 25 percent, the Hansen-Steiger proposal would add some $64 million to this traditional tax subsidy for timber. And close to 60 percent would go to just five giant corporations—an average of over $7 million each!

The minimum tax changes in the House-passed bill are better than Hansen-Steiger only in that they scale back the reductions. H.R. 13511 still would give 76 percent of its basic capital gains benefits to the over $100,000 income class, and tax cuts for 22,000 people with incomes exceeding $200,000 would average almost $27,000 each. Less than 6 percent of all capital gains receipts and only 0.4 percent of all taxpayers would get tax cuts, but almost half of those with gains whose incomes exceed $200,000 would get large reductions. H.R. 13511 still repeals the minimum tax on sheltered gains, and its new "micro-mini" tax is a pitiful substitute. (To illustrate, it would raise only one-eighth the revenue of the exsting minimum tax.)

In addition, the House has added a provision for indexing the basis of capital assets to allow inflation. Such a change might be beneficial in the context of real tax reform (i.e., eliminating the 50 percent exclusion), but it makes no sense so long as only half of capital gains are subject to tax. In fact, one of the cited justifications for the one half exclusion is that it allows for inflationary gains. And that it surely does, it is estimated that in the long run the House's indexing provision would reduce the revenues from taxing capital gains by 50 percent—$3.3 billion in 1978 terms, while indexing coupled with repeal of the 50 percent exclusion would actually double the capital gains tax revenues. If there are extra billions available for tax cuts, they should be used to give relief from inflation and payroll tax increases to average taxpayers, who are far less able to set up hedges against inflation (their money is in savings accounts) than are typical capital gains recipients.

Without concurrent elimination of the 50 percent exclusion for capital gains, indexing represents nothing but an enormous income transfer in favor of wealthy investors. In fact, 54 percent of the cuts would go to the 0.4 percent of taxpayers earning over $100,000 per year. We strongly oppose this provision in the House bill.

Economic arguments

The proponents of repealing the minimum tax have attempted to divert attention from the incredible unfairness of their proposal and the violence it would do to the tax system by spreading around a great deal of economic nonsense. We would like to address some of their arguments:

Hansen-Steiger advocates imply that capital gains tax rates are very high and that a significant number of investors are paying taxes of as much as 49.1 percent on their capital gains. The facts do not bear out these allegations:

An analysis of 1976 tax returns has shown that *nobody* actually pays the so-called minimum rate, and only 14 people—out of 5 million reporting capital gains—pay over 45 percent. Fewer than 2500 individuals are assessed at more than 40 percent on their gains, involving less than 0.4 percent of all capital gains.

Although 80 percent of the benefits of the Hansen-Steiger bill would go to individuals earning *over* $100,000 a year, three-fifths of the capital gains are received by taxpayers with incomes *under* $100,000. The average tax cut from Hansen-Steiger for these less well off capital gains recipients is only $60, and most of them would get nothing at all.

The average effective rate on capital gains income is less than 16 percent, and the Treasury collects only one-third the revenues that would be raised if capital gains were treated as ordinary income. A person which $200,000 in income—all of it capital gains—and typical deductions currently pays an effective tax rate of only 19 percent, including the minimum tax, even under the unlikely assumption that he or she has no other tax shelters. Hansen-Steiger would lower this taxpayer's rate, not to 25 percent, but to only 12 percent.

One of the studies whose title the Hansen-Steiger lobby frequently cites—called "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," by Martin Feldstein and Joel Slemrod of Harvard—attempted to prove that capital gains in corporate stock are overtaxed because of inflation. But the authors were forced to admit that inflation losses are trivial compared to the existing special tax breaks for capital gains. Their data show that if the 50 percent capital gains exclusion were eliminated, in conjunction with full "indexing" for inflation, revenues from taxing stock market capital gains would *double*. Only for taxpayers earning under $20,000 do inflation losses outweigh the capital gains preferences, and this is exactly the group for which Hansen-Steiger would do nothing.

Almost all of the "econometric studies" put forward by Hansen-Steiger proponents simply assume a substantial jump in the stock market in response to enactment of the bill. The guesses range from 6 percent to 40 percent increases in stock prices—in other words, up to a $300 *billion* surge in the market on account of $500 million in tax reductions relating to stock gains, a "multiplier" of *600 times* the cut. At the same time, most of the studies also assume increased "realizations" of capital gains income. But increased realizations means increased *sales*, and increased sales means *lower* stock prices. In fact, one of the papers selectively cited by the Hansen-Steiger lobby—by Norman B. Ture, Inc.—admits that there is "no basis for reliable estimation" of the effects of the bill on stock sales and prices, but "insofar as H.R. 12111 resulted in a significant increase in realization, this would tend to curb the increase in the market value of assets."

The Hansen-Steiger apologists concentrate their arguments on the stock market, but three-quarters of the benefits of the bill would not go to stock investors. Instead, they are scattered over a wide range of assets, including such socially useful investments as jewels, antiques, and rare cars. The big winners would be real estate speculators, and the result could be a driving up of land prices and a further diversion of scarce resources away from productive investments. And the beneficiaries would not be homeowners. Because of the special rollover provisions for personal residences and the partial exemption for retired people, very few homeowners pay any capital gains taxes when they sell their houses, and almost none of them pay the minimum tax. In fact, the President's tax program would exempt home sales from the minimum tax, at a cost of $5–10 million, less than one-half of one percent of the cost of Hansen-Steiger. And in any case there is almost certainly going to be substantial *separate* relief for home sales in whatever bill is approved by Congress; the House bill would provide a one-time total exemption from tax for up to $100,000 in capital gains resulting from the sale of a principal residence.

Apologists for the bill maintain that the maximum tax rate on capital gains is the key to the behavior of the stock market—even if nobody pays it. For example, they contend that the downturn in the market and in revenues from taxing capital gains occuring in 1969 was a direct result of the higher taxes of the '69 Tax Act. The Dow Jones average did drop in 1969, *before* the '69 reforms became effective, but it rose in 1970, 1971, and 1972, *while the higher maximum rate on capital gains was being phased in*. In fact, by the end of 1972 the market was at an all-time high. The sharp plunge in 1973 and 1974 (to below 600 at one point) was unaccompanied by any change in capital gains rates, as was the recovery in 1975 and 1976 (back to almost the 1972 level). The most commonly accepted explanations for the stock market's ups and downs include the business cycle, inflation, investor confidence, political changes, and, of course, corporate performance. The drop in 1969 is usually tied primarily to the enormous stock overvaluations in the mid-60s and the guns and butter inflationary policy pursued by President Johnson. The '73–'74 slump is charged in large part to the energy crisis and Watergate. The '77 downturn has been variously blamed on the health of the dollar, dislike of President Carter, and inflation, among other factors. The point is not that any crystal clear explanation of the stock market is available, but that the maximum tax rate on capital gains has little to do with stock market performance.

A favorite tactic of Hansen-Steiger proponents is to compare our economic performance to that of countries which allegedly do not tax capital gains at all, especially Japan and Germany. The implication is that these nations' economic successes are due to this feature of their tax systems. In fact, although both these nations do exempt casual sales of securities by individuals (after a 6 month holding period in Germany), virtually all other capital gains are taxed in each. Most important, both countries tax gains from the most basic form of "venture capital" similarly to the U.S., treating profits from selling shares of a business in which a taxpayer has a substantial interest as taxable capital gains. In addition, in both countries, all capital gains received by corporations and other businesses are taxed in full as ordinary income. Germany, in fact, taxes such business gains whether or not realized, under an annual increase in wealth measure of taxable income. Italy *is* a good example of a country that actually has no capital gains tax, but it is doubtful we would want to emulate the Italian economic record. (Incidentally, in terms of real growth and employment increases, in recent years the U.S. has outperformed most other industrialized countries, including the three cited here.)

Alternative minimum tax proposals

If, in spite of the damage it would do to tax fairness, the House approach to capital gains tax reductions is adopted, the existing minimum tax will no longer apply to the untaxed half of capital gains. In that case, there is general agreement that some form of alternative minimum tax will have to be devised to maintain at least a modicum of tax equity. The "micro-mini" tax proposal adopted at the last minute by the House is clearly inadequate, but we believe that the administration suggestion embodied in the Fisher-Corman substitute has real merit. This proposal focuses on individuals who not only have large gains, but also have large deductions and shelters that they now use to offset gains—two dollars on the dollar. Under the Fisher-Corman approach, this 2 for 1 angle would be eliminated. Instead, the 50 percent capital gains exclusion would be applied *after* deductions. (An exception is made for charitable contributions, which would retain their current status.) Such a change would not impact on taxpayers already paying taxes on half their gains, and thus it would maintain the goal of the House bill to lower the top possible rate on gains to 35 percent. But it would result in a progressive alternative minimum tax whose rates could range as high as 17 percent on some very high income tax avoiders.

For most of the 48,000 people with incomes over $50,000 who paid less than 10 percent of their incomes in taxes in 1976, the capital gains exclusion was a key factor. For the over $200,000 income group who paid nothing at all, an astonishing 98.6 percent of income was capital gains, and for those in this income class who sheltered more than 80 percent of their incomes (but did pay a little in tax) capital gains comprised 61 percent of income. The minimum tax obviously did not affect the zero taxpayers in this group (who used other deductions and credits extensively), but it did raise the highly sheltered individuals up to an average rate of 7.1 percent (from only 1.5 percent). For the rest of the taxpayers with incomes exceeding $200,000, the minimum tax was not nearly so significant, adding only 2.4 percentage points to their otherwise 33.0 percent average effective rate.

The latest Treasury report on high income tax returns indicate that previous reforms—especially the enactment and strengthening of the minimum tax—have sharply reduced the number of individuals with incomes exceeding $200,000 a year who are able to pay absolutely nothing in taxes. There are still a significant number of high earners, however, who pay very little in taxes—what Treasury calls "nearly non-taxables." If the existing minimum tax on capital gains is to be repealed, we believe that any alternative minimum tax which is substituted for it should focus on this "nearly non-taxable" group.

The House "micro-mini" tax appears to be *less* effective on the nearly non-taxables than even the existing minimum tax. While the current minimum tax on sheltered gains adds close to 4½ percentage points to this group's average effective rate, the House "micro-mini" could reduce this to only 1½–3 points. For example, taking a "typical" high income nearly non-taxable individual based on the Treasury high income report for 1976 (other than a person with large foreign tax credits), with total income of $615,000, including capital gains of $380,000, who has other preferences totalling $50,000 and itemized deductions of $331,000 ($36,000 in charitable contributions), the total tax under current law is about 7.1 percent of expanded income, 79 percent of which comes from the minimum tax. Under the House-passed bill, the effective tax rate would drop to only 4.1 percent. Under the Fisher-Corman proposal, the effective rate would actually increase to 7.9 percent (See appendix for computations.)

The advantage of the Fisher-Corman proposal in sometimes raising rates on high income nearly non-taxables is not obtained at the price of increasing capital gains rates on other high income taxpayers. In fact, as already noted, the proposal creates no burden at all on people who are already paying taxes on one-half their gains. It should also be pointed out that, in spite of some inflammatory rhetoric to the contrary, the Fisher-Corman approach is not particularly complicated, either conceptually or practically. In concept, all the proposal says is that deductions in excess of ordinary income must be deducted from capital gains before applying the 50 percent exclusion. In practice, the computation can be accomplished in a few simple lines on Schedule D (see appendix for example).

The Long and Nelson proposals

There are two proposals to liberalize the tax treatment of capital gains which do not involve repeal of the existing minimum tax. Both would enlarge the current 50 percent capital gains exclusion. Under Senator Long's proposal, the exclusion would be increased to 70 percent; under Senator Nelson's plan, everyone would be granted a flat $1,500 exclusion ($3,000 for joint returns) in addition to the 50 percent exclusion.

Senator Long''s proposal represents a radical structural change in the treatment of capital gains which moves in exactly the opposite direction from where we believe tax refrom should be headed. In fact, we believe that adoption of this approach would set back reform even further than the House bill, bad as that measure is.

Senator Nelson's bill clearly distributes its tax reductions more fairly than any of the other capital gains proposals. Although only 6 percent of all taxpayers—those with capital gains—would be benefitted, at least within that favored group the allocation of benefits is not as shocking as is the case under other measures. The Nelson bill does represent a setback for the tax reform of treating all income alike, but not nearly to the extent of the Long proposal. For these reasons, we certainly prefer the Nelson approach to any of the other capital gains proposals.

Carryover basis

There is some talk that this Committee will use the tax bill as a vehicle for proposing repeal of the carryover basis provisions adopted in the Tax Refrom Act of 1976. We strongly urge the Committee not to take this step. Carryover was one of the most important reforms that has been adopted in a long time, and it would be a tragic mistake to reverse that decision. We recognize that some serious technical difficulties have arisen in the administration of the provision (mainly due to the "fresh start" feature, which we recommended against in 1976). But we believe that the amendments sponsored by Senator Hathaway can solve these problems while retaining the most important elements of the reform. We urge the Committee to support the Hathaway bill as part of the Technical Amendments Act still pending on the Senate floor.

REFORM PROPOSALS

The House severely disappointed tax reformers, and, according to the polls, the American people, when it rejected most of the important tax reforms proposed by the President. Although it would be difficult for this Committee totally to reverse the House decisions, we do believe that a number of reformers addition to the few passed by the House are still possible this year. And some new tax preferences contained in the House bill should be deleted. Any revenues raised by closing loopholes will make available larger cuts for the majority of taxpayers who now shoulder too large a share of the tax burden.

1. Expense account living

Most of the discussion about expense account living has centered around the fabled "three martini lunch," but a substantial amount of business entertainment—and some of the worst abuses—involves non-libationary activities. Most prominent are expenses which can be lumped together under the label "facilities," including such things as yachts, hunting lodges, and swimming pools, and fees paid to country clubs and other social, athletic, or sporting clubs. These "big ticket" items provide substantial tax-free benefits to the few who enjoy them, at the expense of everyone else, and their tax deductibility seriously undermines the fairness of the tax system. Public opinion—as evidenced by recent polls—is strongly in favor of denying these items as tax deductions.

In 1962, when President Kennedy proposed denying deductions for business entertainment, this Committee agreed "that this abuse of the tax law should not be condoned." Rather than disallowing the entertainment expenses entirely, however, the Committee decided to try to fashion rules to prevent some of the most flagrant abuses. After fifteen years of experience with these rules, there is substantial agreement that they have not been successful in achieving their purpose. If the Committee retains its view than abuses should not be condoned, we believe that it is now time to amend the code to disallow entertainment deductions—at least for facilities and club dues.

The problem with a more limited approach, of course, is that restrictions are essentially unenforceable by the IRS. The sea-going surgeon who deducted $14,000 for "consultations" with his friends aboard his yacht, the companies which lease salmon streams in Iceland and villas in Spain. Playboy Enterprises which deducts $2.8 million a year for its two "mansions," and all the rest will maintain as plausibly as they can that *bona fide* business purposes are involved. Faced with their assertions. all carefully—albeit meaninglessly—documented, the Service can do nothing but allow the deductions.

Perhaps more than anything else, expense account living symbolizes the unfairness in our tax system. We strongly urge this Committee to include disallowance of facility and club expenses in the tax bill it reports to the Senate.

2. Tax-free fringe benefits

Current law provides special tax treatment for certain employee fringe benefits whose proliferation Congress wishes to encourage. In the pension area, Congress has established elaborate safeguards designed to assure that plans do not discriminate in favor of highly compensated employees. But with regard to health and life insurance plans there are few, if any rules to mandate that rank and file workers be benefited.

The House bill does establish anti-discrimination rules for so-called "cafeteria plans"—an area in which abuse has been most frequent. We support these provisions, but we think they should be extended. Tax exemptions for all health and life insurance plans should be statutorily conditioned upon compliance with anti-discrimination rules similar to those provided in the House bill for health benefits under cafeteria plans. Such reforms would encourage employers to adopt fair plans by denying tax breaks to the perpetrators of disciminatory arrangements.

3. Investment-tax credit

In the House bill, three major changes are made in the investment tax credit. First of all, the level of the credit, scheduled to revert to 7 percent in 1980 (and to 4 percent for utilities) is made permanent at 10 percent. Second, the credit, heretofore available only for equipment, is extended to rehabilitation of nonresidential commercial structures. Finally, the limit on how much of a taxpayer's taxes can be offset by the credit is increased from the current 50 percent to 90 percent (phased in). All of these changes were proposed by the administration, so we fear that our opposition to them will have little effect.

We would like to point out, however, that when the administration recommended increasing the percentage limit on the credit to 90 percent of tax liability, it would have applied this limit across the board, repealing a provision of current law that lets the first $25,000 in taxes be offset totally. It was this $25,000 rule that allowed President Carter to owe nothing in income taxes for 1976. We do not think the investment credit should be allowed to reduce anyone's taxes to zero. The House bill would allow this result, however, for families earning close to $100.000, or even higher if they are involved in tax shelters, and for corporations with taxable incomes as high as $95,600. Although restricting the tax offset to 90 percent is not much of a limit, it is better than a 100 percent rule. We urge this Committee to amend the House bill to eliminate the $25,000 exception.

4. Tax breaks for pollution control equipment

Laws requiring companies to stop polluting our precious environment have been one of the major achievements of Congress in the past decade. Besides enhancing and lengthening our lives, one of the desired effects of these laws was to put the cost of preventing environmental damage on the producers of products and their customers. In this way, the prices of various goods would reflect more accurately their social cost—a cost previously borne by the general public in the form of a dirtier environment. If some products become too expensive when the full cost is factored in, consumers will switch to other products, or methods will be devised to manufacture the product in a less environmentally damaging way. In either case, strict enforcement of the anti-pollution laws should lead to a much more efficient use of our resources.

There has been an unfortunate trend, however, toward undoing the economic benefits produced by the environmental laws. Through the use of tax-exempt pollution control bonds, companies are able to shift part of the cost of pollution reduction back to the taxpayers generally. Congress also has provided a special five-year writeoff for anti-pollution equipment—with similar effects. And under H.R. 13511, companies would be allowed the full 10 percent investment tax credit for pollution control devices in addition to the fast amortization. (Currently, they lose half the credit if they elect the five-year writeoff.)

These changes not only lead to economic inefficiency in the marketplace; they also discourage many of the best methods of controlling pollution. Because tax-exempt financing and five-year amortization are allowed only for devices that reduce otherwise existing pollution, they provide disincentives to moving to new processes which are intrinsically sounder, both environmentally and economically.

We believe that in its zeal to safeguard the environment, Congress has taken steps which actually undercut its goals. We strongly urge this Committee to reverse that process, first, by denying tax-exempt status to future pollution control bonds and, second, by repealing the five-year amortization provision. The investment credit would then be allowed in full for pollution control investments, which makes economic sense assuming the credit is contained for other capital expenditures.

Companies affected by environmental regulation maintain that public assistance to them is appropriate since they are performing a public service by reducing their pollution. Such claims are totally without merit. The cost of producing products with potential environmental hazards should be borne by the manufacturers and their customers. For companies to allege that they are entitled to relief because of their historical practice of despoiling the environment is absurd.

5. Increasing the small issue exemption for Industrial Development Bonds

H.R. 13511 would increase the special small issue exemption for industrial development bonds from $5 million to $10 million. We urge the Committee to reject this change, and to adopt instead the administration proposals to terminate the tax exemption for IDB's relating to pollution control, industrial parks, and private hospitals (absent a certificate of need) and to limit the small issue exemption to economically distressed areas.

Claims for the effectiveness of IDB's in expanding industry and providing new jobs uniformly assume that each IDB issue results in the net addition of a new factory to an area. This assumption runs counter to a substantial body of literature on industrial location decisions, and disregards some simple economic considerations. Repeated surveys of companies receiving industrial development bond financing show that *over 90 percent of the firms would have located in the same state even without the financing subsidy.* The IDB's simply are not the crucial factor in plant location decisions in the overwhelming majority of cases. Furthermore, studies show that whatever small effect these location incentives may have, it is primarily *intra*regional: Industrial incentives reallocate new plants within a state or between states within a region, but they do not improve the economic outlook of an entire region. *Industrial incentive programs primarily work to divert new companies to one town and away from other towns in the same state, and to one state and away from its close neighbors.*

Industrial development bonds do not increase investment in the country as a whole because they do not increase the stock of capital available for investment. If there is to be a continued role for IDB's, we recommend that the Committee restrict their use to economically depressed areas, as proposed by the Carter administration. This limitation will prevent the dilution of their effects, and will maximize and concentrate whatever impact on unemployment these subsidies may have where it is needed most.

Since IDB's are virtually costless to the state or municipality issuing them (at least directly), little restraint can be expected in their use. Some 47 states and over 14,000 localities are authorized to issue these bonds. From under $18 million in 1958, IDB issues soared to nearly $1.8 billion in 1968 before the Treasury Department urged that the practice be curtailed. Even with these limits, the total amount of IDB's has gone to over $3.5 billion.

State competition to attract business has never been greater. Observers regularly describe the recent escalation as "a second war between the states." Promotional advertising in newspapers and magazines designed to attract industry is up 40 percent this year alone. Increasing the IDB small issue limit to $10 million at this time would set off a costly round of escalation which would ultimately leave no state in any stronger position. The only sure winners would be businesses.

The self-defeating nature of these incentives has been widely recognized. *Fortune noted that* "competition is so keen and the lures are so easy to copy that the predictable has happened." Professors Bennett Harrison of MIT and Sandra Kanter of the University of Massachusetts concluded that "since nearly all of the states follow one another in legislating these incentives, the savings differentials from one state to another are by and large meaningless." The danger is that business will become addicted.

The increase in the IDB ceiling to $10 million will drain an estimated $64 million from the federal coffers over the next five years. The subsidy is inefficient in that it costs the Treasury more than one dollar for every dollar of subsidy provided to industry. Wealthy bond purchasers in high tax brackets receive more in tax savings than industry saves in lower interest costs.

The recent increases in interest rates have dramatically increased the cost of borrowing by localities. The widespread availability of IDB's will inevitably make municipal bond funding for essential services costlier and less available as IDB's crowd a shrinking market.

For all these reasons, we recommend that the Committee adopt the administration proposals on limiting industrial development bonds.

6. Chicken amendment ("Chicken I")

The House bill contains a special interest provision designed to benefit two poultry producers—Halifax Foods of Maine and Hudson Foods of Arkansas—by exempting them from the 1976 reforms requiring large farm corporations to use the accrual method of accounting.

Last year, these same two companies were given a one year reprieve from the '76 changes, based on their complaint that without relief they would be put at a competitive disadvantage vis a vis several other large poultry processors which qualified for a "family farm" exemption in the '76 Act. At the time, the sponsors for the two companies' interests—Senator Bumpers and Senator Muskie—made clear that equal treatment was all they sought. At least three times during the April 28, 1977 floor debate, Senator Muskie noted: "As far as this Maine company is concerned, if the result is an accrual basis across the board, they will take that. . . . They are simply asking for equal treatment." Senator Bumpers was equally emphatic: "All I want is for everybody to be treated alike. Either put them on the cash basis or the accrual basis. I do not care which. . . . We are asking in this amendment for minimal relief, minimal relief simply saying let us postpone the effect of that provision . . . for 1 year, and let the President submit his tax reform bill."

When the President did submit his tax reform package in January, it contained the equal treatment provision which the companies had sought. Under the proposal, the "family farm" exception would be abolished, so that all farm corporations (other than Subchapter S companies) with sales exceeding $1 million annually would be put on the accrual method of accounting. Instead of accepting this change, however, the companies—or at least one of them—reneged. At the insistence of Hudson Foods (the Arkansas producer), the Ways and Means Committee adopted a provision *permanently* exempting these two corporations from the '76 reforms.

We urge this Committee to reject the "chicken amendment" and instead adopt the proposal put forward by the President. It is universally agreed that the accrual method is a fairer and more accurate means of measuring income. In addition, the "chicken amendment" does not achieve the goal of equal treatment. Of the 36 largest poultry producers—of which Hudson Foods is number 24—seven others have had to switch to the accrual method under the '76 Act. To exempt Hudson Foods and Halifax Foods from this requirement is not the "equal treatment" the companies allegedly seek. Rather, it is preferential treatment.

The purposes behind letting farmers use the cash, rather than the accrual method of accounting is the alleged lack of financial sophistication of small farmers. Such a rationale has no appliation to Hudson Foods or Halifax Foods or to any other farm corporation whose sales exceed $1 million annually.

"Typical" person in the nearly non-taxable group with over $200,000 in expanded income. Family of four not using foreign tax credits. (Assumes minimum tax on excess itemized deductions does not apply.)[1]

Expanded income	$615,000
Capital gains exclusion	190,000
Dividend exclusion	100
Other preferences	50,000
Charitable contributions	36,000
Other itemized deductions	295,000
Taxable income	40,900
Current law:	
Regular taxes	9,200
Minimum tax	34,500
Total tax (7.1% of expanded income)	43,700
H.R. 13511 "micro-mini" tax:	
Alternative tax	19,000
Minimum tax	6,000
Total tax (4.1% of expanded income)	25,000
Fisher-Corman alternative minimum tax:	
Addition to taxable income	58,050
Total taxable income	98,950
Regular tax	42,630
Minimum tax	6,000
Total tax (7.9% of expanded income)	48,630

[1] Figures are based on 1976 data in the August 1978 Treasury Report on High Income Tax Returns. Expanded income, long-term capital gains, other preferences, and regular and minimum taxes due under current law are all about average for "nearly non-taxables" with incomes exceeding $200,000.

Examples of capital gains tax computations under current law, Fisher-Corman proposal, and H.R. 13511

Take a person in the following situation:

Taxable income other than capital gains	($—150,000)
Charitable contributions	50,000
Short-term capital gain	30,000
Long-term capital gain	300,000

Under current law, this person's taxes on his or her capital gains are computed as follows (assuming no other items of tax preference):

I. Capital gains included in taxable income

1. Add short-term and long-term gains	$330,000
2. Enter lesser of 50 percent of line 1, or 50 percent of long term gain	150,000
3. Subtract line 2 from line 1	180,000

Line 3 is added to taxable income.

II. Minimum tax

1. Enter preference items	150,000
2. Enter larger of 50 percent of regular taxes paid or $10,000	10,000
3. Subtract line 2 from line 1	140,000
4. Multiply line 3 by .15	21,000

Line 4 is added to taxes due.

Under the Fisher-Corman proposal, the computations are as follows:

Part I, capital gains computation, is exactly the same as above.

II. Adjustment if taxable income other than net long-term capital gains is less than zero

1. Enter taxable income other than capital gains	($—150,000)
2. Enter short-term capital gain (if none, or if a loss, enter zero)	30,000
3. Enter charitable contributions	50,000
4. Enter $5,000	5,000
5. Add lines 1, 2, 3, and 4. If greater than zero stop; there is no adjustment	(—65,000)
6. Enter 50 percent of line 5 (as a positive number)	32,500
7. Enter capital gains exclusion taken on line 2 of Part I	150,000
8. Enter the smaller of line 6 or line 7	32,500

Line 8 is added to taxable income.
The calculation under the House bill is as follows:
Part I, capital gains computation, is exactly the same as above.

II. Alternative tax

1. Enter capital gains exclusion from line 2, part I	$150,000
2. Enter exclusion attributable to personal residence (see instructions)	0
3. Subtract line 2 from line 1	150,000
4. Multiply line 3 by .10	15,000
5. Enter regular income tax liability from line 47, form 1040	5,400
6. Enter the larger of line 4 or line 5	15,000

Line 6 is the amount to be shown on the equivalent of line 47 on form 1040.

Senator BENTSEN. Our next witness is Virginia Martin, executive director, parents without partners.

Ms. GILBERT. I am Jacqueline Gilbert, assistant to the executive director. Ms. Martin was unable to appear.

Senator BENTSEN. Everyone here wants to hear what you have to say, so if you will really move up to that microphone, please proceed.

STATEMENT OF JACQUELINE GILBERT ON BEHALF OF VIRGINIA MARTIN, EXECUTIVE DIRECTOR, PARENTS WITHOUT PARTNERS

Ms. GILBERT. We appreciate the opportunity to address this committee to lend our support to your efforts on behalf of the head of household bill S. 1644.

Parents Without Partners is a nonprofit educational organization of 170,000 members, all of whom are single parents.

During the existence of our organization, we have provided a support system to nearly 1 million single parents—divorced, widowed, separated and, never married. Therefore, we have extensive firsthand knowledge of the struggles, both financial and emotional, that more than 14 million single parents currently face.

Two-thirds of our membership are women while one-third are men. These heads of households experience the same basic expenses—rent, food, medical care, utilities, education, et cetera—as do married heads of households, but are penalized by a tax structure which favors the two-parent or nuclear family. In female-headed households, one in three families live at or below the poverty level.

While nearly one-half of married couples with at least one child are dual-income families, the single parent is the sole source of income in nearly all instances. In 1975, the average family income for heads of households was $8,295. The comparable figure for married persons was $16,775. In just one year, 1976, a single mother's income fell 16.5 percent while the income for intact families rose 33⅓ percent. When the statistic is coupled with the ever-increasing gap between the earnings of women and men and additionally compounded by a smaller standard deduction, further strain is placed on already financially overburdened single parents as well as their children.

There is a ripple effect. If a woman is suddenly faced with having to find a job with inadequate training, she does not have the time or the resource to look carefully, to go to school to improve her situation. She is much more likely to take a low-paid, dead-end job and remain there. Her children, at the same time, are much more likely to be encouraged to leave school as quickly as possible and begin earning money, which keeps them at a lower income, and thus perpetuating the cycle and decreasing your tax base.

The Carnegie report, "All Our Children, The American Family Under Pressure," together with other research reports, clearly illustrate the major impact of inadequate finances on all family structures. In fact, the children of families suddenly experiencing a single-parent-family situation demonstrated problems in direct proportion to the marked decrease in economic security rather than a reaction to their new family status.

In the 1950's and 1960's, a lot of sociological studies were done, especially on delinquently boys, and the conclusions were drawn that there were an inordinate number of single families in the population. The conclusion was there were more children from single-parent families who get in trouble.

They took a new look at this research in the 1970's and the conclusions were quite different, because the populations they had been studying were poor populations. There was a much greater number of single-parent families in that population, therefore the conclusions were erroneous.

If you take out the economic factor, problem children are no more likely to be found in single-parent households than in any other households. It is much more an economic situation. When a single parent, whether woman or man, has to assume all the financial responsibilities of caring for their children and also working, they are going to have less time for supervision of the children, and with inadequate child care available, this will result in children with problems who are problems for all of us, and provide an increased need for social services.

Historically, the nuclear family with the father as sole wage earner has been considered the norm, and the basis for much of current legislation. To ignore or penalize diverse family structures is to ignore or penalize a significant segment of the population. The latest figures tell us that 84 percent of Americans do not live in the model nuclear family.

The administration must recognize reality. Death, divorce, and separation are realities to be dealt with in an equitable manner, recognizing not only present conditions but that the number of single-parent families is increasing.

Of the families with children, single-parent families have had the greatest increase in the last 5 years. Today, single-parent families contain 18 percent of the children under the age of 18, or 13 million children. Of all children now a part of the population, over 30 million will grow up spending part of their lives in single-parent homes.

The fallacy of using tax incentives to promote marriage or to reward the traditional two-parent family continues to the detriment of all single-parent families and their children.

As single parents, we do not ask for preferential tax treatment, only an equitable position in the taxing structure. When we are placed in a position of paying higher taxes on the basis of marital status, the inequities also affect our financial abilities to raise our children.

Take into consideration that upon the termination of a marriage for whatever reason, the custodial parent or head of household suddenly experiences a marked decrease in income while at the same time facing a marked increase in emotional and financial pressures. The combination of these factors has a direct effect on the children involved.

According to the Bureau of Census projections, 45 percent of children born today will spend some time in single-parent families as they grow up. We earnestly request your serious consideration of this bill to restore tax equity to single parents and their families.

Senator BENTSEN. Senator Hansen?

Senator HANSEN. Let me compliment you on your very fine statement. I think you call attention to some disturbing facts. I have no questions.

Senator BENTSEN. Mr. Packwood?

Senator PACKWOOD. Mr. Chairman, I hope that we adopt this. The Finance Committee has twice adopted this provision. Prior to 1975, heads of household got the same standard deduction that married couples did. We only started to change that in 1975. There is now $1,000 difference, and this issue should not be confused with the taxation of single, married couples at the same rate, which is another argument.

These are people with dependents. Normally, a single wage earner as compared to a married couple, gets less of a deduction than a married family. It simply is not fair, considering the obligations.

Senator BENTSEN. Senator Packwood, I do not know anybody in the Senate who has devoted more of his time and interest and concern to trying to take care of that equity than you have.

Senator PACKWOOD. I hope we have another shot at it this time.

Thank you very much.

Senator BENTSEN. Thank you.

Our next witness is Professor Murray Weidenbaum, Washington University.

Professor, it is good to see you again.

STATEMENT OF MURRAY WEIDENBAUM, DIRECTOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY

Mr. WEIDENBAUM. Thank you, Mr. Chairman. It is a real pleasure to be before this distinguished committee once again.

In its action on the current tax bill, the Congress has an important opportunity to set priorities in tax policy for many years to come. I would like to focus on four alternatives to choose from in amending the tax bill.

One, enhancing the equity of the tax system by closing all those "loopholes."

Two, easing the burden on the poor by reducing taxes in the low brackets.

My statement will deal with a lot of the points raised by one of the earlier witnesses in those two areas.

The third alternative is protecting the public from the effects of inflation through so-called indexing.

The fourth is increasing the stimulus for capital formation.

I would like to quickly go through each of the four.

First, closing all those loopholes. Frankly, it is necessary to go beyond the horror stories of the 50 or 30 or 15 millionaires who do not pay any taxes and to focus on the total impact of the revenue system. In passing we should note, however, that at every income level there are people who do not pay any taxes and even larger numbers who do not pay their fair share of taxes. But the overall facts of the matter are very clear: the Federal individual income tax is progressive, in both practice and theory.

To be sure, that statement runs counter to the popular myth that "The poor pay more, so the rich pay less." That, very frankly, is the big lie in tax reform discussion. As any big lie, no amount of repetition can make it true. On the average, the higher your income, the more Federal personal income tax you pay, both absolutely and as a proportion of your income. That has been demonstrated in every comprehensive study of the tax system.

Those who focus on so-called tax expenditures are looking at the hole instead of the donut.

I would like to submit for the record a recent study I have made on so-called tax expenditures which deals with that question.[1]

Even after taking full account of tax expenditures, the Federal personal tax system is progressive. The most recent corroboration of this fact was provided by Secretary of the Treasury W. Michael Blumenthal in testimony earlier this year and table 1 in my statement is taken from his testimony.

It shows that the effective personal tax rate rises steadily with the taxpayer's income and at a more rapid rate—this, of course, is the essence of a progressive tax.

In the interest of time, I would like to skip over some of the statement. My statement is not an attempt to defend every provision of the Internal Revenue Code, but it does seem clear that tax reform, in the sense of closing loopholes, is not and should not be at the top of the agenda for tax policy action.

The second alternative is reducing the tax burden on the poor. Here it is clear from the data in table 1 that the poor pay little, if any, Federal income tax. Moreover, the great bulk of the rapid expansion in Federal spending over the past decade has been in the form of income-maintenance transfer payments, heavily targeted to lower income groups.

Poverty has not been eliminated, but what remains is not a result of unfair tax policy towards the poor. Lack of jobs is a direct cause of poverty, a point I will get to later.

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[1] See appendix, p. 1031.

The third alternative is protecting the public against inflation. Inflation surely is, and surely should be, a key concern. The point that we need to note here is that the Government cannot protect all of its citizens from the effects of rising prices by merely changing the income tax structure. Indexing has a role to play in reducing or eliminating the added taxes we pay when inflation forces us into higher brackets.

It is most helpful in the capital gains area, but indexing itself does not cure inflation. We only delude ourselves if we avoid adopting those often painful but necessary measures of monetary and fiscal restraint.

To those of us who are concerned with the expanding scope of the public sector, reductions in personal and corporate income taxes are an important and constructive step in controlling the size of Government. But so designing tax reduction that it primarily promotes increases in current consumption—that seems to be the main strategy in the House bill—is not the central part of any anti-inflation effort.

Quite clearly, we are led to the fourth alternative shift in tax policy—the encouragement of more capital formation. There is no need to repeat the many studies which demonstrate the existing bias in the United States tax system in favor of consumption and against saving and investment. But it is not surprising that we as a Nation devote a far smaller portion of our GNP to investment than the other industrialized nations, who generally use a tax system which taxes saving and investment far less heavily than does our own.

This long term concern is reinforced by the current outlook for the American economy. Virtually every forecaster is projecting a slower rate of growth for the coming 12 months than was achieved during the past year. A rising minority is forecasting recession sometime in 1979. When we examine the major sectors of the economy, it is clear that capital spending has been lagging.

Tax changes to encourage investment are badly needed to provide needed strength for the economy and the needed jobs that I mentioned earlier. By increasing productive capacity—the ability to supply goods and services—the long term impact of such tax changes would be anti-inflationary.

Other benefits may be achieved. Reasonable people may differ over the most desirable tax changes to encourage capital formation. Reducing the high capital gains tax is one useful and very important approach. In fact, it has been shown before this committee that during periods of rapid inflation, these taxes can be confiscatory. In fact, a substantial reduction in the capital gains tax rate would unlock a great deal of the existing nominal gains and likely generate more than offsetting revenues. Also expanding the investment tax credit and liberalizing the depreciation allowances are other attractive possibilities.

For many reasons, however, I want to focus this morning on a straight, across-the-board reduction in corporate income tax rates.

Of transcending importance, a lower corporate tax rate would reduce the pervasive role of Government in day-to-day business decisionmaking. In this period of rising public concern with overregulation of business, we must realize the pervasive interference with business management that occurs as the result of the tax system. A lower corporate rate would promote more efficient use of resources because fewer business expenses would be incurred merely because they are tax deductible.

A lower corporate tax rate would soften the double taxation of dividends. It is important to keep in mind that the typical dividend recipient is not the fat cat that dominates tax reform folklore. He or she is a retired worker that ultimately receives corporate dividends via a pension plan, an insurance policy, or a mutual fund.

Increased dividends would be only one result of reduced corporate tax rates. To some extent, consumers also would benefit as a portion of the lower taxes is shifted forward in the form of lower prices, or at least prices rising less rapidly than otherwise. Also, some part of the higher after-tax earnings would be shifted backwards to employees in the form of higher wages and fringe benefits.

I would expect that a substantial portion of the higher net earnings of business resulting from cutting the corporate tax rate would be reinvested in the companies themselves. The resultant increases in new plant and equipment would provide the basis for higher production, more jobs, and rising incomes.

For all these reasons, I urge that spurs to saving and investment and capital formation be placed at the top of the agenda for tax policy. The sizable reductions in the personal and corporate income tax rate should be phased in over 3 to 5 years. To get the maximum impact of such long-term action, Congress should pass such action now. Such action would signal clearly the specific tax cuts which individuals and business can anticipate over the next several years and which they could count on as they make their long-term commitments.

The phased tax reduction would also change the environment in which the budget is put together. Rather than merely considering tax cuts as a residual action to be taken after the appropriations review, the process would be reversed. The executive branch would be forced to develop its spending programs in the light of lower flows of revenue.

Thus, substantial tax cuts, such as those to spur private capital formation, would simultaneously encourage restraint in public outlays.

Thank you very much.

The CHAIRMAN. You have made a very interesting statement and I really think, Professor, that everyone in America ought to read that statement of yours, because it helps to overcome a popular misunderstanding.

I would like to direct your attention to a book that I thought was so good that I got copies for every member of this committee and presented it to them. The book is called "Welfare," by Morton Anderson, and it has to do with a parallel misunderstanding. What this man points out in his book on pages 22, 23, 24, and 25, in my judgment proves beyond any shadow of a doubt that the studies that state that 12 percent of our people are in poverty are just as wrong as they can be.

They are overlooking all sorts of factors. They are overlooking unreported income; they are overlooking the noncash value of medicaid and food stamps and things of that sort. They are overlooking imputed income.

For example, if a couple formalizes their relationship by marriage, then the wife is presumed to share a portion of the husband's income. But if they do not formalize it by marriage, under the standard Census Bureau techniques she is said to have no visible source of income, even though she is sharing the house and sharing the income with the man who is living with her, or vice versa, him sharing her income.

If you take all those things into account, you come out to 3 percent in poverty rather than 12 percent.

If we are trying to think of how much money we have to raise to take care of poor people in poverty, that is entirely a different matter than what it appears to be when you look at it at first blush. And then, if you zero in on who these 3 percent are and what the real problem is, you get down to the point that a lot of people are addicts and things of this sort.

The answer is not to give them more money to buy more dope. The answer is to find some way the fellow can do something useful that is not disastrous to his health. The problem becomes an entirely different problem from what some people would like to picture it as being.

What you are saying here in taxation is pretty much that way, too.

Mr. WEIDENBAUM. I share your enthusiasm for Dr. Anderson's brilliant analysis of the welfare program. I am pleased as punch that you link my views on taxes with his on spending.

Thank you very much.

The CHAIRMAN. I am glad you read the book. If you can write one as good on taxes, I assure you I will buy copies for all the committee members also.

Senator Hansen?

Senator HANSEN. I think you made an excellent contribution, Mr. Weidenbaum, to a better understanding of the problems that face this country and are of great concern to this committee. I was especially interested in the observations you made on the last page.

You say that phased tax reduction would also alter the environment in which the annual Federal budget is prepared, and you point out that if we reverse the process, instead of considering tax cuts as a residual action to be taken after the appropriations review, that that, too, would be helpful.

I would ask you, as I have other witnesses, that the preponderance, the overwhelming preponderance of the testimony this committee has had with respect to cutting capital gains taxes, indicates that it would not result in a Treasury loss, but rather Treasury revenue.

Do you share that view?

Mr. WEIDENBAUM. Yes, I do.

As the Senator may know, I received the committee's invitation late last week, and therefore my formal statement is a bit shorter than my oral presentation this morning. In my oral presentation, I precisely made the point that I thought that reductions in the capital gains tax, very frankly as envisioned in your bill, sir, would, by unlocking capital gains, likely more than pay for themselves. That would be a very effective way of not only promoting revenue but, far more important, promoting economic growth.

Senator HANSEN. I appreciate those kind words. The Chairman points out, and traces quite accurately, what happened in the early 1960's and the proposals that were made by President Kennedy. I find great merit in going even further than my proposal does to follow along in making the cuts more significant, receiving the benefit of an even greater feedback that I am certain will result.

I think there is overwhelming evidence to support the logic in a greater tax cut on capital gains.

I must say amen to your statement—which I think is just a jewel—that lack of jobs is a direct cause of poverty.

Mr. WEIDENBAUM. Thank you.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. Just a short review of where we are, Mr. Weidenbaum. I think there has been a lot of talk about capital formation and productivity. Every witness, virtually every witness that we have had, has talked about the linkage between corporate taxation and capital formation and productivity. The President's tax cut proposal that he made last winter recognizes it, because the President proposed reducing the corporate rate phased down to 44 percent. Somehow, though, our focus in Congress has been almost entirely on capital gains taxes, and its relationship to productivity and to capital formation, which is fine. But I think that we have lost sight of the fact that the business tax picture is also very, very important, and the thing that has held the witnesses together that have come before us—really all of them: you, Professor Feldstein, Secretary Blumenthal, even Professor Eisner from Northwestern yesterday, who came here yesterday to testify against reducing capital gains taxes, said that he believed the corporate tax rate should be reduced to zero.

So there is, I think, this general consensus that something should be done about corporate taxation as a part of the total productivity picture.

Mr. WEIDENBAUM. Senator, I have titled my statement "Priorities in Tax Policy" for a very deliberate reason. I think that this committee has a variety of attractive alternatives before it. Let me speak, bluntly; as the chairman of this committee knows, that this is the way I prefer talking.

There are several very attractive alternatives. The Roth-Kemp bill—I only call it Kemp-Roth when I am in the other House—and the Hansen-Steiger bill. They are very attractive alternatives.

My proposal, and I gather in specifics you have introduced legislation for that, for a very substantial reduction in the corporate tax rate, is also a very attractive proposal. So it is not my task, certainly not my inclination, to attack or criticize any of these worthy alternatives, but to indicate where I sit, which I think merits the highest prority. Over many years as a student of the American economy, I have in my writings on taxes have always urged that a large across-the-board cut in the corporate tax rate be given first priority in tax policy.

Very frankly, I reiterate that position this morning. I think that very attuned to that position is the notion that Senator Hansen and I were discussing, that a substantial reduction in the capital gains rate would be consistent with that, because the revenues to the Treasury, if anything, likely increase rather than decrease.

So we literally—we could have, I believe, a substantial reduction in the capital gains rate, at the saame time that we have a substantial reduction in the corporate rate. They are not mutually exclusive.

Senator DANFORTH. In addressing ourselves to capital formation, there are a variety of different types of ways to cut business taxes that could take the form of a rate reduction, it could take the form of increasing the investment credit to over 10 percent. It could take the form of doing something in expanding the accelerated depreciation rate, or indexing depreciation so you can recover the replacement value of assets.

Do you have a view as to the best mix, or the best synthesis that we could take if we took the position that capital formation is the issue we wanted to address?

Mr. WEIDENBAUM. As many of the members of this committee know, in the last few years, I have been making a detailed analysis of the American business system. I am concerned that government has increasingly called the shots, literally controlled so many of the day-to-day operations of the business system.

Very frankly, every time the Congress passes another—albeit very well-intentioned—specific piece of tax or expenditure legislation, encouraging or directing business to perform a certain way, that reduces still further business management prerogatives and flexibility and efficiency.

Therefore, it is with the greatest of enthusiasm that I urge an across-the-board reduction in the corporate rate which would reduce the role of the tax collector in business decisionmaking. I view that, very frankly, as part of a regulatory reform approach broadly conceived—part of a necessary reduction in the role of government in the operation of the private sector.

Senator DANFORTH. You do not see a corporate rate reduction as an ineffective means of stimulating business invesment?

Mr. WEIDENBAUM. I think that it will have a very positive effect on business investment. However, quite clearly, it will have broader effects than a more targeted measure such as increasing the investment credit or liberalizing depreciation allowances.

As I pointed out in my statement, it likely will have a beneficial effect on individuals, on the consumer, because some major portion of the lower corporate tax (business is the middleman or middlewoman) will flow through to the consumer in the form of either lower prices or, at least, less rapidly rising prices.

And some portion likely—I think this also has been our experience—will shift back to labor in the form of more generous wages, salaries and fringe benefits.

So the impact of a corporate rate reduction would be widely diffused throughout the entire economy.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Professor, one of the witnesses the other day suggested if we want to get the most bang for our buck we should make the corporate tax rate effective in 1981, raise the investment credit to 12 percent, and phase it out in 1981, so companies would begin to invest immediately and take advantage of the investment tax credit, knowing full well in 1980 or 1981 they may have a 40 or 50 percent tax rate. Is that valid?

Mr. WEIDENBAUM. Senator, that kind of fine-tuning really runs counter to the points I have been making. If we really want to increase private sector decisionmaking, get the Government out of calling the shots, we have to, rather than go the fine-tuning approach, really reduce the Federal presence in the business system. And you do not reduce that presence by juggling the investment tax credit, but by having a long term reduction in business tax rates.

Senator PACKWOOD. The witnesses were saying it does not make any difference if you do it now or say it is going into effect in 1981. The decisions business will make are the same.

Mr. WEIDENBAUM. My confidence in those econometric models that underlie those conclusions is pretty modest. As a user of those models, I have been burnt so frequently, particularly during my years in the Treasury, that I am not quite back to using the back of the envelope, but not only a pinch of salt, but a whole dose of salt, should be sprinkled over computer runs.

Senator PACKWOOD. I have no further questions.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you, Mr. Chairman.

Professor, you made a very fine statement. I am very pleased to have you again before us.

The figures I have seen show in real dollars the amount of money that is invested per new worker that is added to the work force in the last 20 years has very materially been reduced. It might have been in the area of $55,000 per worker. It is now in the area of the low 40's. That cannot do anything but reduce productivity, can it?

We had a previous witness talking about the fact that Japan and Germany, because of the devastations of the war, had to put in new plants, and all that is true, but it has been over 30 years now, and we cannot just keep living in the past and justifying our noncompetitive position by that. It seems to me we have to have some very strong incentives for investment in manufacturing and modernization in that capacity.

In 1974, I recall we got up to about 98 percent in our productive capacity, that general area—maybe 91—then we began to have shortages in some critical industries and that began to leapfrog across and we ended up with some very substantial inflation. But with the deterioration of our manufacturing capacity, it seems that that tolerance keeps going down further all the time, and that you end up with inefficient productivity, and it has to bring us more inflation and a less competitive position.

Mr. WEIDENBAUM. You describe a very important concern to the future of the American economy. Clearly, we are not investing enough in the future of the American economy, and if we look at tax systems here and abroad, it is very clear—maybe unintentionally—but we have a tax system that is punitive toward saving, investment, and capital formation, and I think the so-called tax reformers that focus on the hole instead of the donut, as I described it in my statement, are doing us a very great disservice.

I happen to be a believer in the progressive income tax system, progressive tax system. Consistent with that, I think that we can and still have a progressive overall tax system, have very substantial reductions in taxes to stimulate the capital formation.

Moreover, I think with a larger economy, that would result every segment of the population, including in fact, and especially, the low income of part of the population that lacks jobs or lacks adequate full-time jobs would benefit. In fact, in a very dynamic sense, if you get away from the static models, I think that a major tax stimulus to capital formation would so expand the economy that it is precisely the lower income part of the population that would benefit to the greatest degree, because that is where the unemployment is heavily concentrated.

The fully-employed middle-income classes will not benefit as much from the emonomic growth as the presently underemployed or unemployed income classes.

Senator BENTSEN. In watching the business pages, I note so many of the takeovers have been by cash tenders rather than by stock exchangers. It seems to me that one of the reasons is that they can buy undervalued assets with the cash purchase rather than going and investing that cash themselves in new equipment, that there has not been incentive to do that. They have chosen the other route, and that does not really add to productivity. That is just an amalgamation of forces. That is just not investing in new equipment. Is that not correct?

So that the investment decision is guided by what the tax figures are?

Mr. WEIDENBAUM. Senator, that is an unfortunate but logical type of action, given the operation of the tax system in a period of inflation which taxes nominal business income, nominal capital gains, which in real terms are close to zero, and often negative.

The CHAIRMAN. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

First, I want to say to you that I plan to take your welfare book down to Rehoboth next week during the Labor Day recess and read it on the beaches. But I was pleased to hear the chairman talk about your thoughtful statement.

I must say, Mr. Chairman, I also hope that this means that you agree with the last paragraph that we ought to establish tax policy now, not only for this year, but for the years down the road.

Mr. Weidenbaum, I feel in many ways that the most important thing you say—and I agree with most of the things that you say—is that we should not have tax policy determined after we decide the rest of what we are going to do on the expenditure side of the government. And that is the whole point of the Roth-Kemp tax cut, to set a policy now, not only for this year, but the several years down the road, both with respect to business and personal.

And it does seem to me, if I understand what you are saying, that we have a tail wagging the dog and it is about time that we leapfrogged and made tax policy in the economy the upfront thing that we work on.

I have never seen it better said than you did in your statement, and I just think that it is so important that tax policy be decided not year by year, but we lay the groundwork now.

Let me ask you this question. Secretary Blumenthal, when he has before us admitted, in answer to my question, that probably they would be coming back next year or the following year for new tax cuts, and it would be even further down the road.

Does it not make sense now to plan what we are going to do the next several years? As Alan Greenspan says, we are probably going to have tax cuts in the amounts proposed in the Roth-Kemp bill, but on a year-by-year basis rather than by planning ahead.

Mr. WEIDENBAUM. In my opinion, Senator, your point is absolutely right. Let me emphasize. One of the reasons that we get large budget deficits year after year is precisely doing the expenditure and the appropriation planning in the executive branch, and budget review in this branch in the context of a larger flow of revenue than actually results. Why? Because the expenditures are planned, say over a 5-year plan, and the tax policy comes in annual installments.

If we had any hope for reducing, slowing down the growth of Government in the United States, it is precisely via the action upon tax policy and precisely, as you put it, that this committee has a unique opportunity for leadership in enacting a long-term program of tax reduction which sets the tone for budget planning in both the legislative and executive branches on both revenues and the expenditures.

Senator ROTH. In my judgment, that is the only way you are going to meet the President's goal of reducing from 23 to 22 to 21 or 20, as others have proposed, the percentage of GNP that is spent in the public sector by the Federal Government.

I applaud what you are saying. I might say, for that reason, the Roth-Kemp bill is the only anti-inflationary proposal before us, because we are making that commitment and there is no way, no way you are going to hold down this growth of government unless you hold down the revenue.

I could not agree more strongly with you, and applaud you for what you are saying, and hope you will get the message across. Because, frankly, those who want to keep government growing fast, increase spending, are raising the bugaboo of inflation and other things. They argue cut expenditures first because the big spenders know we can never hold down the growth in government that way. Would you agree?

Mr. WEIDENBAUM. It is a question of horse and cart, and the horse here has to be major tax cuts. And, very frankly, Senator, I feel that those who overestimate the direct revenue effects of long-term tax cuts do us a disservice. I was asked recently by Chairman Ullman to comment on your bill, and I was, very frankly, I was surprised and disappointed, and I so said. That despite my great admiration for the work over the years of the Joint Committee on Internal Revenue Taxation, the staff of that committee estimated the revenue effects assuming no feedback on either the supply or the demand side, I thought that was totally unsupportable.

Senator ROTH. May I ask one further question, Mr. Chairman?

The CHAIRMAN. Yes.

Senator ROTH. I think it is a matter of serious importance.

You make reference to the bad examples in your testimony. One of the reasons I think we find ourselves where we are with a tax policy that is negative in helping economic growth and job creating in the private sector, is the fact that those who want income transfer use a few bad examples to popularize their point of view.

The recent Roper poll shows that the majority of the American people feel everybody ought to pay some taxes, including the very rich, and one of the reforms that I think—and I am not an expert on this, Mr. Chairman—one of the reforms that I think we need is a true minimum tax, not an add-on, but one which really gets to those who are paying no taxes.

It is amazing to me to hear the President berate the people who are paying no taxes when last year he admitted he paid no taxes. There is something contradictory about that.

But I think it is wrong that he, or anybody else, is in that position.

So I think that one of the things we need to do is have an effective minimum tax that frankly applies to State and local bonds, as unpopular as that is, so that everyone is being taxed, if somebody can lay to rest these bad examples that are used as rationales and excuse for income transfer.

Mr. WEIDENBAUM. Senator, also, those bad examples remind us of the underlying reason, and it is specifically the high personal and corporate tax rate to begin with, that motivate investing all the time and effort in the tax lawyers and tax accountants rather than in productive economic activity.

I think that the only industry that would suffer if there was a major reduction in tax rates would be the tax accounting, tax lawyer industry. Not being a part of the industry, of course, I am not concerned about the maintenance of full employment in it.

But, very frankly, I am not surprised that when the Congress imposes burdens of up to 70 percent, in nominal terms, on taxpayers, you motivate them to put an awful lot of resources, not in productive economic activity, but in tax avoidance.

The way out, I do not think, is to go after those who have taken advantage of the tax incentives, but to reduce the incentive to go that route by major reductions in Federal, corporate, and ultimately individual income taxes.

Senator ROTH. May I ask, you would agree that it is desirable now to pass legislation that will relieve much of the burden on business together with a substantial across-the-board tax cut that would have as a goal, I would say, reducing the tax range to 50 percent to perhaps 8 or 10 percent over the next Federal years?

Mr. WEIDENBAUM. Senator, I may have a different view as to the precise emphasis on corporate individual taxes. As I look at the tax system in my preferred tax structure of the 1980's, I would like to see tax reduction weighted more heavily to the corporate side than is envisioned in most of the existing proposals.

But over the coming 5-year period, I think that the American people would benefit from a phased reduction in income tax rates, corporate and individual, but phased at one point in time for the reasons we discussed.

Senator ROTH. Thank you.

The CHAIRMAN. I think that your presentation would have an even better balance if you would undertake to provide us with a chart to put a third column in your table that would show us on the taking down end how much these various groups receive. For example, when you take the group of less than $5,000, that is where most of the welfare benefits and the other benefit expenditures occur.

If you would undertake to find the best information you can for that purpose, then I think you could find some studies along that line.

It would help to provide some balance and show not only where the different groups stand on the putting up end, but where they stand on the taking down end.

Mr. WEIDENBAUM. I do not have the data with me. I have done that in the past, and I assure you that your instincts are absolutely correct, that at the lower income classes, their share of Federal expenditures is very high so that, on balance, they are very substantial recipients of Federal money, and at the upper bracket, their share of expenditures is very low so, on balance, they are net contributors to Federal revenue.

I will be glad to prepare for the record.[1]

The CHAIRMAN. If you cannot find any later study on that subject, a fellow named Herman Miller included in his book, "Rich Man, Poor Man," a chart on this subject. I think it would help complete and balance what you have to say here.

I would also appreciate it if you would provide us with a biographical background of yourself for the record.[2]

Mr. WEIDENBAUM. Yes, Mr. Chairman.

[The prepared statement of Mr. Weidenbaum follows:]

PRIORITIES IN TAX POLICY

(By Murray L. Weidenbaum)[3]

In its action on the current tax bill, the Congress has an important opportunity to set the priorities in tax policy for many years to come. There is no shortage of alternatives to choose from: (1) enhancing the equity of the tax system by closing all those "loopholes," (2) easing the burden on the poor by reducing taxes in the low brackets, (3) protecting the public from the effects of inflation through adjusting the personal income tax structure ("indexing"), and (4) increasing the stimulus for capital formation.

Let us briefly evaluate each of these four alternatives to see which merits greatest priority.

CLOSING ALL THOSE LOOPHOLES

Frankly, it is necessary to go beyond the "horror stories" of the 50 or 30 or 15 millionaires who don't pay any taxes and to focus on the total impact of the revenue system. In passing we should note, however, that at *every* income level there are people who do not pay any taxes and even larger numbers who do not pay their "fair" share of taxes. But the overall facts of the matter are very clear: the federal individual income tax is progressive, in both practice and theory.

To be sure, that statement runs counter to the popular myth that "the poor pay more, so the rich pay less." That, very frankly, is the big lie in tax reform discussions. On the average, the higher your income, the more federal personal income tax you pay, both absolutely and as a proportion of your income. That has been demonstrated in every comprehensive study of the federal individual income tax.

Those writers who focus on the distribution of "tax expenditures" (the revenues lost from special provisions) are looking at the hole instead of the donut. Even after taking full amount of tax expenditures, the federal personal tax system is progressive. The most recent corroboration of this fact was provided by Secretary of the Treasury W. Michael Blumenthal in testimony earlier this year. Table 1, taken from the Secretary's statement, shows that the effective personal tax rate rises steadily with the taxpayer's income and at a more rapid rate—this is the essence of a "progressive" tax.

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[1] See appendix, p. 1031, for supplementary statement.
[2] See appendix, p. 1031, for biographical background.
[3] Mr. Weidenbaum is Director of the Center for the Study of American Business at Washington University in St. Louis and adjunct scholar at the American Enterprise Institute.

Table 1—Federal personal income tax rates under present tax law

(Based on 1976 levels of income)

Expanded income class	*Effective tax rate (percent)*
Less than $5,000	0.2
$5,000 to $10,000	5.5
$10,000 to $15,000	9.0
$15,000 to $20,000	11.2
$20,000 to $30,000	13.8
$30,000 to $50,000	17.6
$50,000 to $100,000	24.4
$100,000 to $200,000	29.5
$200,000 and over	30.0
Average	12.4

There is no need to guess the average citizen's reaction to the equity of the federal income tax. The Advisory Commission on Intergovernmental Relations recently reported its survey of taxpayer attitudes. By a substantial plurality, the American public believes that it gets the most for its money from the federal government. The local property tax receives the "honors" for being considered the most unfair tax (see Table 2).

Table 2—Citizens reactions to government and taxes

"From Which Level of Government Do you Feel You Get the Most for Your Money?"

	Percent
Federal	36
Local	26
State	20
Don't know	18
Total	100

"Which Do You Think is the Worst Tax—That Is, the Least Fair?"

	Percent
Local property tax	33
Federal income tax	28
State sales tax	17
State income tax	11
Don't know	11
Total	100

(Source: Advisory Commission on Intergovernmental Relations.)

Although the passage of Proposition 13 in California demonstrated the public's general concern with high taxes and big government, it is interesting to note that the proposition focused on the local property tax.

My statement is not an attempt to defend every provision of the Internal Revenue Code. But it does seem clear that tax reform in the sense of closing "loopholes" is not—and should not be—at the top of the agenda for tax policy action.

REDUCING THE TAX BURDEN ON THE POOR

It is clear from the data in Table 1 that the poor now pay little if any federal income tax. That was not always the case, but it surely is true today. Moreover, the great bulk of the rapid expansion in federal spending over the past decade has been in the form of income-maintenance transfer payments. These federal expenditures are heavily targeted to the lower income groups of the population.

Poverty surely has not been eliminated in the United States. But what remains is not the result of unfair tax policy toward the poor. Lack of jobs is a direct cause of poverty, a point we will take up a little later.

PROTECTING THE PUBLIC AGAINST INFLATION

Inflation surely is a key concern of the American people. The point that we need to note here is that the government cannot protect all of its citizens from the effects of rising prices by merely changing the income tax structure. Surely, "indexing" can reduce or eliminate the added taxes which we pay when inflation forces us into higher tax brackets.

But indexing itself does not cure inflation. We only delude ourselves if we avoid adopting those often painful but necessary measures of monetary and fiscal restraint which can help subdue the inflationary pressures. Reforming needlessly costly government regulations is an important part of any comprehensive anti-inflationary effort.

To those of us who are concerned with the expanding scope of the public sector at the expense of the private sector, reductions in taxes are an important and constructive step in controlling the size of government. But so designing tax reduction that it primarily promotes increases in current consumption—which appears to be the main strategy of the current tax bill—surely is not a central part of any anti-inflation effort.

So, quite clearly, we are led to the fourth alternative shift in tax policy—the encouragement of more capital formation. As we will see, there are many reasons to believe that this is the most desirable of the proposals now under consideration.

ENCOURAGING CAPITAL FORMATION

There is no need to repeat the many studies which demonstrate the existing bias in the U.S. tax system in favor of consumption and against saving and investment. But it is not surprising that we as a nation devote a far smaller portion of our GNP to investment than the other industrialized nations, who generally use a tax system which taxes saving and investment far less heavily than does our own.

This long-term concern is reinforced by the current outlook for the American economy. Virtually every forecaster is projecting a slower rate of growth for the coming 12 months than was achieved during the past year. A rising minority is forecasting recession sometime in 1979. When we examine the major sectors of the economy, it is clear that capital spending has been lagging far behind what normally would be expected during this stage of the cycle.

Tax changes to encourage investment in economic growth are badly needed to provide needed strength for the economy. By increasing productive capacity—the ability to supply goods and services—the long-term impact of such tax changes would be anti-inflationary. Depending on which specific changes are adopted, a variety of other benefits could be achieved.

Reasonable people may differ over the most desirable tax changes to encourage capital formation. Reducing the high capital gains taxes is one useful approach. In fact, it has been shown that during periods of rapid inflation these taxes can be confiscatory in real terms. Also, expanding the investment tax credit and liberalizing depreciation allowances are other attractive possibilities. For a variety of reasons, however, I support a straight across-the-board reduction in corpoarte income tax rates.

Of transcending importance, a lower corporate tax rate would reduce the pervasive role of government in day-to-day business decision making. In this period of rising public concern with overregulation of business, we must realize the pervasive interference with business management that occurs as the result of the tax structure. A lower corporate rate would promote more efficient use of resources because fewer business expenses would be incurred merely because they are tax deductible.

A lower corporate tax rate would soften the double taxation of dividends. It is important in this connection to keep in mind that the typical dividend recipient is not the "fat cat" that dominates tax reform folklore. Rather, he or she is a retired worker that ultimately receives corporate dividends via a pension plan, an insurance policy, or a mutual fund.

Increased dividends would be only one result of reduced corporate tax rates. To some extent, consumers also would benefit as a portion of the lower taxes is shifted forward in the form of lower prices, or at least prices rising les rapidly than otherwise. Also, some part of the higher after-tax earnings would be shifted backwards to employees in the form of higher wages and fringe benefits.

I would expect that a substantial portion of the higher net earnings resulting from cutting the corporate tax rate would be reinvested in the companies themselves. The resultant increases in new plant and equipment would provide the basis for higher production, more jobs, and rising incomes. For all these reasons, I urge that spurs to capital formation be placed at the top of the agenda for tax policy and that sizable reductions in the corporate income tax rate be phased in over a period of three to five years. To get the maximum impact of such long-term action, the Congress should pass the entire package now. Such action would signal clearly the specific tax cuts which business can anticipate over the next several years and which it could count on as it makes its long-term commitments.

The phased tax reduction would also alter the environment in which the annual federal budget is prepared. Rather than considering tax cuts as a residual action to be taken after the appropriations review, the process would be reversed. The executive branch would be forced to develop its expenditure programs in the light of a lower anticipated flow of revenues. Thus, substantial tax cuts, such as those to spur private capital formation, would simultaneously encourage restraint in public outlays.

The CHAIRMAN. Next, we will hear from Mr. Edward I. O'Brien, president, Securities Industry Association.

Mr. O'BRIEN. Good morning, Mr. Chairman and gentlemen.

Accompanyiing me today is George L. Ball, the president of the Securities Industry Association's Tax Policy Committee, and president of E. F. Hutton Co.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY GEORGE L. BALL, CHAIRMAN, TAX POLICY COMMITTEE, SIA, AND PRESIDENT, E. F. HUTTON & CO., INC.

Mr. O'BRIEN. We very much appreciate this opportunity to testify before this committee whose members recognize the need to improve the tax bias against investment. With your permission, Mr. Chairman, we would like our full statement included in the record, and would like to summarize our full statement verbally.

Because of its essential role in the capital markets, the industry daily observes the impact of tax policy on investment decisions by corporations and investors large and small. On several occasions, SIA testified that higher capital gains taxes impede capital mobility and the flow of risk capital.

We have seen investors locked in to their existing investments or seeking alternative investments with higher aftertax returns than stock investments. In our professional judgment, capital gains tax incentives are needed to attract individual investors, to stimulate investment in new venture enterprises and to lower dangerous high debt-equity ratio of many corporations.

Studies have been undertaken by SIA and other organizations indicating that lower capital gains taxes would increase rather than decrease tax revenues, would stimulate investment and capital formation and reduce the imbalance of corporate balance sheets.

The securities industry is alarmed by the impact since 1969 of increased taxes on returns from investment.

In 1969, capital gains marginal tax rates were increased from 25 percent to 45 percent.

Since then 6 million investors have left the stock market.

The portion of Americans' savings invested in stocks dropped from 40 percent to 25 percent.

Federal tax revenues from capital gains declined.

The number of small businesses issuing new stock offerings plunged from 548 to 4, capital raised by those offerings dropped 99 percent.

Economic growth, capital formation, and productivity lagged.

The Nation experienced two recessions.

While there were several reasons for these trends, there is no question that sharp increases in taxes on investment returns were a contributing factor.

Last year, SIA contracted with Data Resources, Inc. to simulate the impact on the economy of nine alternative tax proposals. The results are included in the attached study, entitled, "Tax Policy, Investment, and Economic Growth."

The study showed that lowering the tax burden on the returns from investment will stimulate economic growth, increase employment, encourage capital formation, and increase Federal tax revenues. This study was not limited to static analysis, but reflected feedback effects in the economy.

SIA has updated the original study by asking DRI and Dr. Norman Ture to evaluate three additional proposals: One, the House bill; two, Senator Hansen's bill; and three, President Kennedy's 1963 tax proposals with respect to capital gains.

The econometric simulations of the House bill were completed prior to final passage by the House and do not include amendments which indexed capital assets and provided an exclusion for homeowners.

In an excellent statement Tuesday, Former Treasury Secretary Fowler outlined President Kennedy's proposal to reduce the portion of capital gains subject to tax from 50 percent to 30 percent and to cut additional tax rates.

The simulations modify the Kennedy proposals in two respects: (1) The individual tax rates proposed by President Kennedy were adjusted to provide reductions for all taxpayers; and (2) an alternative minimum tax of 15 percent was added.

Under present law, marginal capital gains tax rates can exceed 49 percent, and sometimes higher. This marginal rate would be reduced to 35 percent under the House bill, to 25 percent under the Hansen-Steiger proposal and to 19.5 percent under the modified Kennedy proposal.

The data resources results are shown on page 7 of our statement. As the table shows, the capital gains provisions of the House bill increase real GNP by $63 billion and capital formation by $29 billion. Over 1 million additional man-years of employment would be created from 1979–1983. Tax revenue would go up by $23 billion.

The DRI projections for the Hansen-Steiger bill show real GNP increasing $98 billion over the time period analyzed. Capital formation jumps $46 billion, the number of man-years of employment increases over 1.6 million. Tax receipts rise by $33 billion.

President Kennedy's 1963 tax proposals had an even stronger impact. Real GNP increases by $122 billion. Capital formation goes up by $58 billion. Over 2 million additional man-years of employment are created. Tax revenues rise $42 billion from 1979 to 1983.

The CHAIRMAN. What does DRI stand for?

Mr. O'BRIEN. Data Resources, Inc., Mr. Chairman.

The CHAIRMAN. Go ahead.

Mr. O'BRIEN. I would like to present Dr. Ture's results which are contained on page 9 of our statement.

According to Dr. Ture's analysis, the capital gains provisions of the House bill would increase real GNP by $51 billion from 1979 to 1983, and capital formation by $43 billion. The number of jobs would expand by 70,000 in 1982 or 1983. There would be no decrease in tax receipts to offset these beneficial results.

The projections for the Hansen-Steiger bill are even more promising. Real GNP would rise by $76 billion; investment by $56 billion. The peak impact on the number of jobs is 110,000 in 1981 or 1982. Tax receipts increased by $6 billion.

Finally, the impact of the modified Kennedy proposal is by far the strongest of the three. Real GNP jumps $211 billion over the period 1979 to 1983. Investment spurts $158 billion. The number of jobs increases by 300,000 in 1983. Federal tax receipts are up by $15 billion.

Data Resources' and Dr. Ture's projections differ in magnitude concerning the impact of these three proposals on the economy. Each organization uses its own econometric model and methodology, for that matter. That is the very reason why we want to confirm the directional results of these proposals by consulting with two independent organizations.

As both of these studies clearly demonstrate and as I have noted earlier, lower capital gains taxes will stimulate economic growth, increase capital formation, create jobs and increase tax revenues.

In general, lower taxes increase GNP through stimulating consumption and/or investment. However, reducing taxes on capital gains has a particularly strong impact on stimulating investment relative to consumption.

The advantages of stimulating investment relative to consumption are really crucial. Stimulating investment increases the capital stock and therefore the Nation's production and employment potential. This allows the economy to meet future demand with less inflationary pressure.

By tilting the ratio of GNP devoted to investment closer to the 12-percent ratio considered necessary by the U.S. Bureau of Economic Analysis, the economy's ability to meet stated national objectives will be improved considerably.

Several bills, including some sponsored by members of this committee, move in that direction. Mr. Chairman, the House bill is an important step toward reversing the present tax bias against investment. In view of what our studies show, we urge this committee to consider combining the House bill with the capital gains tax proposals first put forth by President Kennedy.

Mr. Chairman, we would be happy to answer any questions the committee may have. I should also inform you that Dr. Joseph Kasputys of Data Resources and Dr. Ture are here today to answer any questions about their particular area that the members of the committee may have.

The CHAIRMAN. Let me make this suggestion to you, Mr. O'Brien.

I don't know much about this computer business. All I know is that if things are working right, you push 2 plus 2, and it comes out 4 on the computer. But we need to take the components apart and see whether you are right, because if what you say is right, then we would be doing this Nation a horrible disservice to continue ridiculously high, counterproductive tax rates to discourage people from doing things that are socially advantageous and economically advantageous to this Nation.

One, by reducing the rate, we would make money for the Government, put more people to work, help to provide a better life for everybody. Now, if some idiot, by not knowing how to estimate the dynamics in the economy, is responsible for a sluggish economy, we ought to make him lay it out so that you can try to understand it. People have difficulty understanding this issue now.

I have tried to compare the Treasury estimate up here to shooting at a duck. If you are aiming right at the duck when you shoot, you have got to miss him. There is no way that you are going to hit that duck, if you are aiming at him, and he is flying in front of the line. You have to shoot in front of him. I am not saying that you will hit him, but you have a chance to hit him, if you shoot in front of the duck. Any duck hunter can tell you that if anybody tells you to aim at the duck, he is wrong. He does not know anything about hunting ducks.

The same thing is true about making the economy move. If these people down there at the Treasury—frankly, some of this mischief might be coming from our own joint committee staff, or coming down from the Federal Reserve, whoever these people are who can't see that this economy is a moving thing. At least it ought to be a moving thing, just like the Nation ought to be moving. If they can't see the effects of motion, then we had better get those people out of there, because they might get seasick under the kind of leadership that this Nation ought to be having.

We have a chance, then, to get the thing right. Can you give us any suggestion as to how we might work on something like that?

Mr. O'BRIEN. At the outset, Mr. Chairman, just as a personal note, it warms me to hear that you, too, are not as efficient in the workings of the computer. It has long been my problem, and I am glad to hear that somebody as esteemed as the chairman of this committee is not up on the computer.

Our professional judgment is that something needs to be done. It is our judgment as investment bankers and securities people. Therefore, we retained the services of DRI and Dr. Ture to see if we could confirm it.

One suggestion that I might offer for your consideration and that of the other members is that we could get together the people we have associated with ourselves, some of your staff, Dr. Ture, some of the people from the Treasury. There must be an answer to this. We would be very glad to try to offer assistance and help to bring about a better understanding or perhaps a solution, if that is acceptable.

The CHAIRMAN. That is what I will try to put in motion. I will ask our staff right now to make some plans to contact you, and to work with you in this matter.

There are so many bad decisions or instances of bad judgment inside the Government, that it could destroy this Nation. Let me give you an example. On the energy bill, those people at the Department of Energy came up with an estimate that paying more than a certain price for gas would not get you one more cubic foot of gas.

They testified for a year to that, and they even convinced Secretary Schlesinger, and he sat down and explained it to me, and almost convinced me, and I should have known better. Eventually, we found out how they arrived at that. Do you know how they arrived at that conclusion? They arrived at that conclusion by saying that you only have a certain number of rigs, and at that price all the rigs would be active. What they overlooked was the fact that the Nation has the capacity to put up more rigs.

Mr. O'Brien. Then we should go after more rigs.

The Chairman. If you had followed that philosophy during World War II, you would not have drafted any more soldiers because you only had so many tanks, or you only had so many airplanes—so why train more soldiers? In other words, you would have overlooked the fact that the Nation had the capability of building more weapons.

If that kind of thinking is in our tax structure, and in the people who are making what should be the responsible decisions, all I can say is—God save this country. We have got to defeat those people.

I want them to work with you, and you to work with them, and then you will take the leadership in this to see if you can break this down so that somebody can understand what we are talking about, because it seems to me, by their own admission, that they are proceeding to shoot at the duck and assuming that the duck is standing still in the air.

Mr. O'Brien. Obviously, we think that they are wrong. Let's see what we can find out to bring some light to that subject. We will try.

The Chairman. Thank you.

Senator Hansen?

Senator Hansen. Mr. O'Brien, I am delighted every time hear you make a presentation before this committee. It seems to me that if people will take the time to listen to you, and to hear what you say, and ponder on it, they are going to have to agree with the inescapable logic of your conclusions.

I want to say this also, Mr. Chairman. They say that politics is the art of the impossible. A couple of years ago I was scared that we were not going to be looking at the prospect of reducing taxes on capital gains. But there were those who occupied some pretty prominant roles in Government who thought that that whole concept ought to be abolished completely as though there was no such thing as a capital gain, and that we ignore inflation.

Then, when Bill Steiger introduced the proposal that he introduced in the House, it encouraged me to think that there might be a little hope at the end of the tunnel. I got busy, and as the chairman knows, I rounded up some 63 of us in the Senate, and we will have some help from others when it comes up for a vote. I would like to believe that my effort gave some encouragement back to the House side.

Right now I go on record as being in favor of the proposal that the chairman has come up with. This is not just a good idea, it is a better idea. If it makes sense to reduce, as I believe it does, capital gain so that not more than 25-percent maximum rate shall apply. I think that there is even greater merit in the proposal that has been offered by our chairman, whom I esteem.

Having said that, I would hope that you might give us a little idea that will reflect an accurate profile of the investors in America. I think that it is important that the public generally understand that what is in this bill will help everybody. Let's talk about, if we may, older people, and women who are dependent upon pension benefits and who might possibly become investors again.

We have had 6 million people leave the stock market. What sort of people are those? What about young women, who have some income, and who might want to invest that.

Single people, generally, offer great promise to put their money, rather than in consumptive ventures, into job-producing ventures.

Could you take just a few minutes to tell us what you think an accurate profile of the people who might be reached and who might become investors in job-creating activities in America could be?

Mr. O'BRIEN. Let me start, and then my colleague, Mr. Ball to give his own reaction.

In my own case—it is always good to personalize things—I became interested in investment at home at the age of 14 or 15. Within a few years, I began making a few modest investments. So here is an example of a young person.

My own mother who is 86 has invested, and not invested in enormous amounts, for many, many years. Between those two ends of the spectrum, 15 or so and 86, you will find that you will have an attraction for more and more people to the securities industry.

They will be attracted to different types of investments. New types of companies which are beginning, innovative companies, which we know as a fact will provide more jobs to more people, and in turn tax revenues to the country. Others will invest in companies where they will use the income for purposes of retirement, or as a supplement, or for purposes, as an example, of educating their children.

So what I am saying is, in a word, it will flow across the spectrum of America from different age groups and income groups, all of whom will be encouraged by some sort of an action proposed by you or the chairman, and others. Mr. Ball may want to amplify on that.

Mr. BALL. Just briefly. Some 20 to 22 percent of all the common stock in America is owned by individuals who are over 65 years of age. In many cases, that stock is no longer appropriate for their current circumstances. There are many, many cases, according to surveys that our firm has done, where they are reluctant to sell the stock and pay the capital gains tax. Yet it is the wrong form of ownership or asset allocation for them.

The average investor, I believe, is 53 years old. There is a great change in the common stock owning age group. One variation of your bill would bring back many of the young people in their late 20's and early 30's, who tend, on balance to make more adventurous investments, often in the smaller companies, the embryonic company that does provide a great deal of job opportunity per dollar of capital invested.

I think that on those particular ends of the spectrum, you will find a great social benefit to our nation.

Senator HANSEN. I have not asked for this privilege often, but if the chairman would indulge me for one more question.

Would you not agree with me that we shall encourage active support for the free enterprise system throughout America? I think that there is no question if we make a comparison between our system and others, ours is far and away the best.

Is there any better way of getting people on board, actively involved in America, than to let them be participants in a way that will offer them reward?

Mr. O'BRIEN. I happen to believe that very firmly. As a matter of fact, I feel so strongly about this subject that in the years 1977-78, I have probably traveled 40- to 50,000 miles throughout this country emphasizing the nature of the problem and getting people to understand it, so that perhaps something can be brought to bear, to correct it.

The fact of the matter is, give people the chance to own and to participate, they are going to take an interest, and they are going to be very viligant of what happens in the tax structure, in the running of the company, or whatever it happens to be.

So the trick is to broaden, rather than to suffocate ownership of equities in this country. After all, that is what this country all about.

Senator HANSEN. Thank you very much.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Byrd.

Senator BYRD. No questions.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. No questions.

The CHAIRMAN. Senator Dole?

Senator DOLE. I think you suggest on page 11, that the greatest gain in GNP is achieved if all taxes on capital gain are eliminated. Do you suggest the committee go beyond the Hansen proposal, and the chairman's proposal?

Mr. O'BRIEN. At this stage of the game, Senator, while that might be a very fine objective, realistically, it may be, perhaps, too much to hope for.

I am saying that at least we should go past the House version, and I think we should embrace the proposal which Senator Hansen himself has, in fact, endorsed this morning—the chairman's proposal.

Senator DOLE. You mention in another part of your statement, that the study was done before the adoption of the so-called Archer amendment. Have you had a chance to focus on indexing?

Mr. O'BRIEN. I don't know what the answer on that is. Perhaps I can check with one of my associates.

Mr. BALL. We have not, Senator, not yet.

Senator DOLE. Do you support that concept?

Mr. O'BRIEN. We do have some work which has been completed on that by Dr. Ture. I don't think that Data Resources has done anything on the subject. We will be very glad to share that with you, if you would like to have it.

Senator DOLE. That gets into the question of indexing, which many of us have a rather broad interest in. It might be useful to have your views on the limited application of the Archer amendment.

Mr. O'BRIEN. We will be glad to furnish it to you, Senator.

[The following was subsequently supplied for the record:]

SECURITIES INDUSTRY ASSOCIATION,
Washington, D.C., August 31, 1978.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: During the colloquy following SIA President Edward I. O'Brien's testimony before the Committee on August 24, 1978, Senator Dole requested the results of econometric simulations on the "Archer amendment", which indexes capital assets for inflation. Dr. Norman B. Ture has examined the effects of this provision, and his results are enclosed.

Data Resources, Inc. has not specifically examined the Archer amendment. However, DRI did simulate the effects of an alternative mechanism to adjust capital assets for inflation as a part of SIA's original study. The "sliding scale" approach examined on pages 36 and 37 (excerpt enclosed) of SIA's paper entitled *Tax Policy, Investment and Economic Growth* is similar to a proposal narrowly defeated (39 to 43) by the Senate in 1976.

Direct comparison of the two sets of results would not be valid because of fundamental differences between the proposals and between the two econometric models. Nonetheless, the economic and revenue projections are positive for each proposal.

I hope the enclosed material will be responsive to Senator Dole's inquiry and useful to the Committee.

Sincerely,

STEPHAN K. SMALL,
Director of Congressional Relations.

Enclosures.

ECONOMIC AND TAX REVENUE EFFECTS OF THE ARCHER AMENDMENT IN H.R. 13511 INDEX CAPITAL GAINS

[Dollar amounts in billions of constant 1977 dollars]

	1979	1981	1983	1988
Increase or decrease (−) in:				
Employment (thousands of full-time equivalent employees)	310	350	400	560
Annual wage rate	$270	$330	$390	$590
Gross national product:				
Total	43	56	70	111
Business sector	34	42	51	79
Gross private domestic investment:				
Total	24	45	69	59
Nonresidential	21	42	63	50
Consumption	19	11	2	52
Federal tax revenues: Net of feedback	10	10	9	15

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

[Excerpt]

TAX POLICY INVESTMENT AND ECONOMIC GROWTH

A COMPARATIVE ANALYSIS OF THE ECONOMIC EFFECTS OF ALTERNATIVE TAX PROPOSALS AFFECTING INVESTMENT INCOME

TAX PROPOSAL NO. 8—SLIDING SCALE ADJUSTMENT FOR INFLATION

Economic variable and change from baseline forecast

Gross National Product (1978–82)—Increased $87 billion (1978 dollars).

Capital Formation (1978–82) (fixed business investment)—Increased $38 billion (1978 dollars).

Man-Years of Employment (1978–82)—Increased 1,300,000.

Jobs (peak effect)—Increased 390,000 (1981).

Federal Tax Revenues (1978–82)—Increased $28 billion (current dollars).

Under this proposal, the portion of a capital gain subject to taxation declines according to the length of time the asset has been held. For assets sold after being held for one year, the proportion of the gain subject to tax is 50 percent. This proportion decreases by 2 percent per year, reaching a minimum of 10 percent for assets held 21 years or more. This proposal would not alter existing law with regard to tax rates, the minimum tax or the maximum tax.

Behavioral assumptions

This proposal assumes a decrease of 5 percent in the dividend payout ratio. Furthermore, stock prices are assumed to rise by 10 percent. These assumptions are the same as for proposal No. 7 but the tax reduction is less than in proposal 7.

Empirical results

Estimated effects of this proposal are shown in detail in table 8 of appendix 'A' and in charts 8.1–8.4 (see the following page).

Gross national product.—Gross national product is higher by $28 billion (1.2 percent) in 1982 with a total growth in output over the 5-year period of $87 billion.

Investment and fixed business assets.—Business investment increases by $13.5 billion in 1982 and almost $38 billion for the 5-year period as a result of the stronger economy, greater cash flow and the lower cost of capital. The capital stock and potential output rise by 1.7 percent and 0.3 percentage point, respectively by 1982.

Employment and unemployment.—The unemployment rate is lowered by 0.3 percentage point in each year from 1980 to 1982, and over 1,200,000 additional man-years of employment are created from 1978 to 1982.

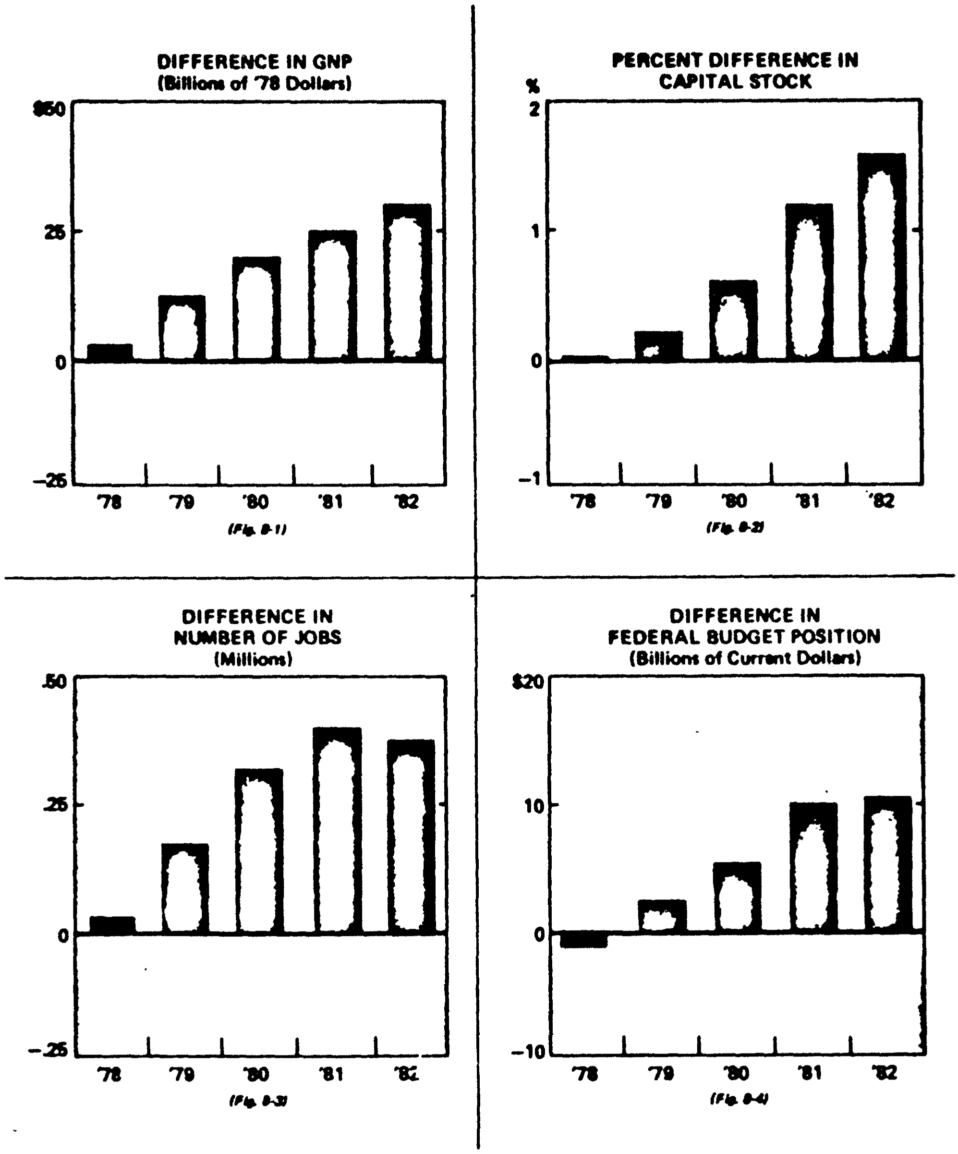
Personal income and consumption.—Personal income expands by $12 billion (0.7 percent) in 1982, and consumption is increased by almost $15 billion. Over the 5-year period, consumption is higher by $45 billion.

Corporate balance sheets.—The increase in after-tax profits resulting from the stronger economy and reduced dividend payments (due to the greater attraction of capital gains), enhance corporate cash flow by a maximum of almost 5 percent in 1981. The maximum change in the debt-equity ratio is a decrease by over 6 percent relative to the baseline in 1982.

Tax receipts and the deficit.—Tax receipts decrease by $0.7 billion in 1978. In succeeding years, Federal tax receipts are increased by as much as $11 billion in 1982. The effect on the deficit is similar. Budget surpluses for 1981 and 1982 total $16 billion.

Inflation.—The stronger economy causes the rate of inflation to rise relative to the baseline by slightly more than 0.1 percentage point per year as explained more fully on page 20.

PROPOSAL – 8



Senator DOLE. I share the view expressed by the chairman that people take the same models and get different results. It is difficult for us to make a judgment. We would like to believe that everything in your statement would happen. If it were the case, we would be less than responsible by not acting on everything that was said.

Mr. O'BRIEN. One thing that we are fairly certain of, while they argue over some of the dimensions of what would happen, the directions of the study are sustainable. Therefore, you should take reasonable satisfaction and comfort from that fact.

Mr. BALL. I would like to point out that many of us run our businesses with uneven success, but on balance successfully, using the DRI model as really one of the keys on which we make investment and asset allocation decisions. It has proven to be very valid over the years.

Senator DOLE. Do you think the tax structure has been a direct cause of the small investors abandoning the securities market?

Mr. BALL. Most certainly, yes. I say that the hope or belief that there will be lower capital gain taxes in the future is one of the major determinants in the stock market's recent rise.

Senator DOLE. I think I heard a witness, yesterday suggest the stock market is going to collapse.

Mr. O'BRIEN. I heard that the comment was made. I will give you my reaction, and Mr. Ball will give you his.

The fact of the matter is, we are convinced that a certain measure of increase in the stock market in the last several months is attributable to the expectation and the aspiration, if you can put it that way, that something will be done to bring some relief in this area. So the question is, will the effective date be this time, or that time. Hopefully, it will be done as soon as practicable, or promptly. But I do not accept the premise at all that it would cause a major reduction in the market, just the opposite. The incentives are going to stimulate.

Mr. BALL. There are two things, very quickly. The flip of the argument is the logical conclusion that raising the capital gain taxes to 100 percent will drive the market up to infinity. It is hard to accept.

More pragmatically, our firm does, on a constant basis, survey the clients who bought stock: Why did you buy, and what are the most important reasons. The belief that the capital gains taxes will be decreased has been the second most often cited reason for people buying stock over the last several months. It is a fairly narrow survey, 300 or 400 people a week, but it probably is indicative.

Senator DOLE. I think that is a good response. We may have planted a seed by mentioning the increase in the rate. However, I don't think that will happen in this committee.

Thank you.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. O'Brien, I believe that you were here when Mr. Wiedenbaum testified. One of the most important things that I think is developing out of these hearings, and the discussions of tax reform during the last 2 years, is the importance of establishing a long-range tax policy. I wonder if you would care to comment.

In other words, what I am talking about is that instead of this piecemeal approach that we have adopted with respect to taxes in the past, with a tax cut this year and maybe a tax cut 2 or 3 years down the road—I am talking both about business and personal taxes—it is important, from several standpoints, that we adopt now a long-term program.

I think it is important that we signal we are moving in a new direction, that we intend to give the private sector an opportunity to show what it can do, that what we are doing this year is not a temporary aberration. Senator Hansen discussed it last year, and his concern that we move in the other direction in the capital gains area.

I think that it is important, that we establish now what the policy is going to be, and that it is going to be one that will build confidence.

Second, I think that this is the only way that you are going to hold down the rate of growth of Federal spending, by telling the budget people, by telling the various committees that only so much revenue is coming in. Then they can plan accordingly.

I wonder if you would care to comment; do you agree as to the importance of this?

Mr. O'Brien. I have a couple of reactions to it. The first, I think that certainty is terribly important in making investment decisions, whether by an individual or by a corporation which is planning an expenditure of several millions of dollars. So certainty as to what the future is going to bring is very important, and the best way to achieve that is to have a measure of understanding of what is going to happen.

Second, I should tell you that there is a measure of skepticism around the country with respect to tax reform. I think that people are of the opinion, the feeling, if you will, that what is given to them today, will be taken away tomorrow.

If they have the feeling that we have moved in a new direction and we are not going to reverse that direction in an arbitrary fashion, or in a premature fashion, I think you are going to get more confidence which, in turn, will make for a much better result.

So, I agree with it, and I hope that it is not too long an answer.

Senator Roth. It is a very interesting observation at this point, and a very sound one.

I would like to make the observation that one of the reasons, I think, we are not talking about higher capital gains taxes, one of the reasons that we are not talking so much about income transfer, which has been basically what has been behind the so-called tax reform movement that is dressing up what I think was an effort to take tax money away from middle America, where the revenue has to come from, the reason that we have this new tax climate is because we are involved in a tax revolt, and the American people are angry. They are angry about Federal taxes as well as State and local taxes.

For that reason, I think it is very important, as we talk about what can be done in the business or private side, that it also be recognized that the American people, as individuals, have to share in these tax cuts in a very substantial way. I think that it is a very serious mistake to try to push business taxes and not provide a substantial across-the-board tax cut for the American people.

I would think that this would be important to your industry because if we are going to have greater participation on the part of individuals, there will have to be great savings. For that reason, I would think that it would be in your interest to see that kind of a tax cut brought about as well.

Mr. O'Brien. I think that it would be a step in the right direction. It would provide more funds for investment, and more discretionary income. It has got to be a step in the right direction.

Senator Roth. Thank you, Mr. Chairman.

Thank you, Mr. O'Brien.

Senator Byrd. Just one quick question. Refresh my memory, if you will, how many less investors do we have now as compared to the pre-1969 Tax Reform Act which changed the capital gains rate?

Mr. Ball. Six million fewer. It is now 25 million, and it was 31 million.

Senator Byrd. While you mention the public being skeptical about tax reform, every speech I make in Virginia, I urge the people of Virginia to view with great skepticism any legislation with the word "reform." The so-called labor reform legislation means more power for the national labor union leaders. Every tax reform act that we have had in recent years has meant higher taxes for the average citizen. The so-called welfare reform, both the Nixon proposal and the Carter proposal, would double the number of people on welfare and greatly increase the cost of welfare.

So I hope that you are right, that people are taking a skeptical view of tax reform. Insofar as I am concerned, I am encouraging them in my State of Virginia to take a very hard, skeptical view of any legislation with the word "reform."

Thank you, gentlemen, both of you.

Mr. O'Brien. Thank you, Senator.

[The prepared statement and attachment of Mr. O'Brien follow:]

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee, my name is Edward I. O'Brien, and I am president of SIA. Accompanying me today is George L. Ball, chairman of SIA's Tax Policy Committee and president of E. F. Hutton & Company, Inc. We appreciate this opportunity to testify before the committee today.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market-making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

TAX POLICY, INVESTMENT AND ECONOMIC GROWTH

The securities industry is alarmed by the consequences of increased taxes on returns from investment since 1969. Due to its essential role in the capital markets, the industry daily observes the impact of tax policy on investment decisions by corporations and investors. On several occasions, SIA testified that higher capital gains taxes impede capital mobility and the flow of risk capital.

High income investors have been locked into their existing investments rather than investing in new companies or sought alternative investments in real estate or tax-exempt securities. Studies undertaken by SIA and other organizations indicate that lower capital gains taxes would increase rather than decrease tax revenues by unlocking substantial unrealized gains.

SIA contracted with Data Resources, Inc. (DRI), the economic consulting organization, to simulate the impact on the economy of nine alternative tax proposals in June 1977. The nine tax proposals chosen for analysis were selected last summer from those either: (1) reportedly then under consideration by the Administration; (2) previously considered by Congress; or (3) contained in the April 1977 report, "Tax Policy and Capital Formation," prepared by the Joint Committee on Taxation. The attached study, entitled Tax Policy, Investment and Economic Growth, was completed and published in March 1978.

The SIA/DRI study showed that lowering the tax burden on the returns from investment will stimulate economic growth, increase employment, encourage capital formation and increase federal tax receipts. The study was not limited to static analysis. Rather, the methodology compared the value of key economic variables to those projected by DRI under existing tax policy. The effects of the alternative tax proposals were then expressed in terms of deviations from these baseline projections.

SIA has updated the original study by evaluating specific proposals which have subsequently been introduced or discussed by members of the Senate Finance or House Ways and Means Committees by simulating their impact on the economy. The methodology used was identical to that employed in the original study. The three proposals examined are: (1) the Revenue Act of 1978—H.R. 13511—without the inflation adjustment; (2) Senator Hansen's bill; and (3) President Kennedy's 1963 Tax Proposals with respect to capital gains modified to incorporate an alternative minimum tax.

DESCRIPTION OF PROPOSALS TO REDUCE CAPITAL GAINS

As passed by the House, the Revenue Act of 1978 would eliminate capital gains from the list of preference items. This action eliminates the indirect tax on capital gains which can result under current law from the effect of preference items on the maximum tax. In addition, the minimum tax, which under present law is paid in addition to other taxes, is replaced by an alternative minimum tax. The econometric simulations of the House bill contained in this testimony were completed prior to final passage by the House, and thus exclude the House amendments with regard to indexing capital assets and the one-time $100,000 exclusion of capital gains resulting from the sale of a taxpayer's primary residence.

Legislation sponsored by Senator Clifford Hansen and 62 of his colleagues in the Senate would also exclude capital gains from preference items. But, the House and Hansen bills move in opposite directions with regard to the alternative capital gains tax. Under current law, the taxpayer may choose a 25 percent tax rate on the first $50,000 of gains annually. The House bill would repeal the alternative tax while Senator Hansen's proposal would remove the $50,000 ceiling.

In 1963, President John Kennedy proposed fundamental changes in capital gains taxation. The Kennedy proposal included a reduction from 50 percent to 30 percent in the percentage of capital gain subject to tax and reductions in individual tax rates lowering the top rate to 65 percent. Kennedy also proposed, extending the holding period for long-term capital gains from six months to one year, a step which Congress took in 1976. In addition, Kennedy proposed a modification in the treatment of capital gains at death. Testifying before this Committee in 1963, then Secretary of the Treasury Douglas Dillon suggested that this change would be accomplished by ". . . provision either for the carryover of basis or for taxation at the time of transfer at death. . . ." The Congress chose the former option in the Tax Reform Act of 1976. Congress has thus adopted the conditions for President Kennedy's proposed reductions in capital gains without providing the relief contained in those proposals.

The simulations contained in this testimony modify the Kennedy proposal in two respects to conform with subsequent developments: (1) the individual tax rates proposed by President Kennedy were adjusted to provide reductions for all taxpayers; and (2) an alternative minimum tax of 15 percent was added. Individual tax rates have been changed since President Kennedy's proposal; some rates are now lower than those proposed in 1963 while others remain higher. No minimum tax existed at the time of President Kennedy's proposals. The minimum tax was created in 1969 at a rate of 10 percent and was increased to 15 percent in 1976. The House bill substitutes an alternative minimum tax at a rate of 10 percent.

Under present law, marginal capital gains tax rates can reach as high as 49 percent. This marginal rate would be reduced to 35 percent under the House bill, to 25 percent under the Hansen-Steiger proposal and to 19.5 percent under the modified Kennedy proposal.

RESULTS

Based on DRI's econometric model, Table 1 on the following page synthesizes the impact of these three proposals using five indices. The first column shows the estimated net change in gross national product at 1978 price levels for the five-year period 1979–1983. The second column shows the cumulative change in non-residential fixed investment (fixed business assets) in 1978 dollars. The third column indicates the change in the number of man-years of employment created over the time period studied. The fourth column shows the largest single year increase in the number of jobs as compared to DRI's baseline forecast. The last column shows the five-year change in federal tax revenues in current dollars.

Under the capital gains provisions of the Revenue Act of 1978, without the inflation adjustment for taxes on capital gains (Archer Amendment), real GNP would increase $63 billion, capital formation by $29 billion, over 1,000,000 additional man-years of employment would be created from 1979–1983 and 337,000 more jobs would exist in 1983. Furthermore, tax revenues are increased by $23 billion.

The projections for the Hansen-Steiger bill show real GNP increasing $98 billion over the time period analyzed. At the same time, capital formation jumps $46 billion, the number of man-years of employment increases over 1,600,000 and the peak effect on the number of jobs is 520,000 in 1982. At the same time, tax receipts rise by $33 billion.

Of the three specific capital gains proposals SIA and DRI analyzed recently, President Kennedy's 1963 Tax Proposals (modified for tax rates contained in the Revenue Act of 1978 and to include an alternative minimum tax of 15 percent· had the most beneficial impact on the economy. Real GNP increases by a robust $122 billion; capital formation rises by $58 billion: and over 2,000,000 additional man-years of employment are created. The peak effect on the number of jobs takes place in both 1982 and 1983 with an additional 659,000 jobs created. Furthermore, tax revenues rise $42 billion from 1979–1983.

TABLE 1.—BASED ON ECONOMETRIC MODEL OF DRI

Tax proposal	Change in real gross national product, 1979–83 (billions of 1978 dollars)	Change in capital formation—fixed business assets—1979–83 (billions of 1978 dollars)	Change in man-years of employment, 1979–83 (thousands)	Peak impact on jobs	Change in Federal tax revenues, 1979–83 (billions of current dollars)
Revenue Act of 1978 (H.R. 13511)	+63	+29	+1,080	[1] +337	+23
Hansen-Steiger (S. 3065, H.R. 12111)	+98	+46	+1,640	+520	+33
President Kennedy's 1963 capital gains proposals	+122	+58	+2,120	+649	+42

[1] 1982.
[2] 1982–83.

For purposes of comparison, SIA requested Dr. Norman Ture's analysis of the capital gains provisions of the Revenue Act of 1978 (excluding the Archer Amendment) and the Hansen-Steiger bill. SIA also asked Dr. Ture to simulate the effects of President Kennedy's 1963 capital gains tax proposals.

According to Dr. Ture's analysis, the capital gains provisions of the Revenue Act of 1978 would increase real GNP by $51 billion from 1979–1983; capital formation by $43 billion; the number of jobs would expand by 70,000 in 1982 or 1983 and there would be no decrease in tax receipts to offset these beneficial results.

The projections for the Hansen-Steiger bill are even more promising, although the time period is for 1978–1982 rather than 1979–1983. Real GNP would rise by $76 billion; investment by $56 billion, the peak impact on the number of jobs is 110,000 in 1981 or 1982 and tax receipts increased by $6 billion.

The impact of the modified Kennedy proposal is by far the strongest of the three. Real GNP jumps $211 billion over the period 1979–1983; investment spurts $169 billion; the number of jobs increases by 300,000 in 1983; and federal tax receipts are up $15 billion.

TABLE 2.—BASED ON ECONOMETRIC MODEL OF DR. TURE

Tax proposal	Change in real gross national product, 1979–83 (billions of 1978 dollars)	Change in capital formation—fixed business assets—1979–83 (billions of 1978 dollars)	Peak impact on jobs	Change in Federal tax revenues, 1979–83 (billions of current dollars
Revenue Act of 1978 (H.R. 13511)	+51	+43	[1] +70,000	
Hansen-Steiger[2] (S. 3065, H.R. 12111)	+76	+56	[1] +110,000	+6
President Kennedy's 1963 capital gains proposals	+211	+158	[3] +300,000	+15

[1] 1981–82.
[2] Covers 1978–82 rather than 1979–83.
[3] 1983.

DRI's and Dr. Ture's projections differ in magnitude concerning the impact of these three proposals on the economy. The two models differ in several respects. For one thing, Dr. Ture's model does not take into account the impact of changes in stock prices or in the propensity to realize gains on tax revenues and the economy. DRI expresses GNP and fixed business investment in 1978 dollars, but measures revenue impact in current dollars. Dr. Ture utilizes 1977 dollars throughout.

Despite such differences, the two models are remarkably similar in projecting beneficial economic results for each of the three proposals and maintain a consistency of ranking among the three proposals. Of the three tax proposals, the DRI and True models estimate that President Kennedy's 1963 Proposals with respect to capital gains, modified to include an alternative minimum tax, would have the largest beneficial impact on the economy. Following next in relative desirability are the Hansen-Steiger bill and then the House provisions with respect to the minimum tax and the alternative capital gains tax. Thus, two independent models using different methodology concur that reduced taxes on capital gains will produce economic benefits. The detailed findings of DRI and Dr. Ture are included in Appendix A and B, respectively.

MARCH 1978 SIA/DRI STUDY

The findings of DRI and Dr. Ture support the results embodied in the SIA/DRI study published in March 1978. As noted earlier, that study simulated the effects of nine tax alternatives for the five-year period 1978–1982, and compared the performance of the economy under each alternative proposal to DRI's baseline projection. The results of the original nine simulations are discussed below and are summarized in Table 3.

At the time the SIA/DRI study began, the Carter Administration was considering a proposal to tax capital gains as ordinary income and reduce the highest marginal tax rates to 50 percent. Even with a full offset against ordinary income for capital losses, such an approach (Proposal No. 1) is shown to have a negative impact on the economy over the period 1978–1982. Real GNP would be lowered by $48 billion, capital formation reduced by $43 billion, well over 450,000 man-years of employment would be lost and the Federal government would lose over $5 billion in revenues.

Without providing for a full offset of all capital losses against ordinary income, the treatment of capital gains as ordinary income (Proposal No. 2) is shown to be even more damaging. Real GNP would drop by $115 billion, capital formation would fall by $73 billion, more than 1,500,000 man-years of employment would be lost and the Federal government would lose over $25 billion in tax revenues.

TABLE 3.—ANALYSIS OF NINE ALTERNATIVE TAX POLICIES BASED ON ECONOMETRIC MODEL OF DRI

Tax proposal	Change in real gross national product, 1978–82 (billions of 1978 dollars)	Change in capital formation—fixed business assets—1978–82 (billions of 1978 dollars)	Change in man-years of employment 1978–82 (thousands)	Change in Federal tax revenues, 1978–82 (billions of current dollars)
1. Capital gains treated as ordinary income, with the maximum marginal rate on income, other than wages and salaries, set at 50 percent. Capital losses fully offsettable	−48	−43	−477	−7
2. Tax proposal number 1 with current loss treatment retained	−115	−73	−1,529	−25
3. No taxation of capital gains	199	81	3,136	38
4. Dividend deductibility at corporate level	171	49	2,969	−21
5. Partial integration via shareholder credit	144	26	2,656	18
6. Combination of tax proposals numbers 2 and 5	50	−32	1,414	−11
7. Deferral of taxation for investment rollover	103	42	1,629	19
8. Sliding scale adjustment	87	38	1,283	28
9. Corporate tax cut from 48 percent to 46 percent	37	12	597	−7

Eliminating the distinction between capital gains and ordinary income constitutes one extreme. For purposes of comparison, the effects of the other extreme—eliminating all taxes on capital gains (Proposal #3)—was also tested. Of the nine original simulations, this produces the largest five-year gain in real GNP—nearly $200 billion. It also has the greatest impact on capital formation, as fixed business assets increase by $81 billion. In addition, this proposal creates over 3 million additional man-years of employment and increases tax revenues by $38 billion over the five-year period.

Dividend deductibility at the corporate level (Proposal #4) has a very positive impact on the economy. Of the nine proposals analyzed in the original SIA/DRI study, it has the second most favorable impact on real GNP, capital formation and the number of additional man-years of employment. However, this proposal has a high cost—Federal tax revenues are reduced by $21 billion from 1978 through 1982.

Partial integration of individual and corporate taxes through a shareholder credit (Proposal #5) also results in a more robust economy. It has the third greatest positive impact on real GNP and the number of additional man-years of employment. This proposal has a smaller beneficial impact on capital formation than does dividend deductibility. However, in contrast to the reduced tax revenues resulting from dividend deductibility, partial integration would increase Federal revenues by $18 billion.

A proposal to compensate for elimination of the current treatment of capital gains by offering relief on the double taxation of dividends (Proposal #6) produces mixed results. The positive aspects of partial integration mitigate, but do not offset, the negative effects of increased capital gains taxes. While this proposal would increase real GNP, five of the other eight result in substantially greater growth. Four other proposals create more man-years of employment. Moreover, this proposal reduces capital formation by $32 billion and results in a loss of Federal tax revenues.

Deferring taxes on capital gains through an investment rollover (Proposal #7), adjusting capital gains for inflation via a sliding scale (Proposal #8) and lowering the corporate tax rate from 48% to 46% (Proposal #9) are all similar in their impact, although the magnitude of their effects differ. All three lead to an increase in real GNP, a rise in capital formation and additional employment. Of the three, only the corporate tax cut reduces Federal revenues over the time period studied. Deferring the taxation of capital gains has the strongest positive impact on economic activity of these three proposals.

CONCLUSION

The various studies produced by SIA show that reducing the tax burdens on returns from investment will stimulate economic growth, increase employment, encourage capital formation and increase federal tax receipts. In general, lower taxes increase GNP through stimulating consumption and/or investment. However, reducing taxes on capital gains has a particularly strong impact on stimulating investment relative to consumption. The advantage of stimulating investment relative to consumption are crucial. Stimulating investment increases the capital stock and therefore the nation's production and employment potential. This allows the economy to meet future demand with less inflationary pressure. In effect, by tilting the ratio of GNP devoted to investment closer to the 12% ratio considered necessary by the U.S. Bureau of Economic Analysis, the economy's ability to meet stated national objectives will be improved considerably.

APPENDIX A

STATISTICAL TABLES

This appendix contains 6 tables, showing detailed simulation results conducted by DRI for (1) the Revenue Act of 1978—H.R. 13511 without the inflation adjustment; (2) Senator Hansen's bill; and (3) President Kennedy's 1963 Tax Proposals with respect to capital gains. Tables A1–A3 show results under the assumption that monetary policy is accommodating, while Tables A4–A6 contain results assuming non-accommodating monetary policy.

TABLE A1.—REVENUE ACT OF 1978 WITHOUT THE ARCHER AMENDMENT ACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	1.6	8.1	15.1	18.8	19.3
Nonresidential fixed investment difference (billions of 1978 dollars)	.3	2.6	6.5	9.5	10.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.5	10.6	10.8
Difference	0	.1	.2	.3	.3
Potential gross national product (percent difference)	0	0	.1	.1	.2
Personal consumption expenditures difference (billions of 1978 dollars)	1.3	5.3	8.5	10.3	11.1
Personal disposable income difference (billions of 1978 dollars)	1.1	3.2	6.1	8.4	8.9
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.8	5.3	5.2	4.7
Difference	0	−.1	−.2	−.2	−.2
Jobs difference (thousands)	21.0	126.0	268.0	337.0	324.0
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	4.9	4.2	3.6	4.5
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.7	6.0	5.6	5.6
New rate	5.6	5.8	6.2	5.9	5.8
Nonfinancial corporate gross internal funds (percent difference)	.4	1.4	2.3	2.7	2.8
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−50.5	−27.5	−15.0	−11.8	−2.1
Difference	−.4	1.9	5.3	7.6	8.3

TABLE A2.—HANSEN-STEIGER BILL ACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	1.9	12.0	23.3	29.7	30.9
Nonresidential fixed investment difference (billions of 1978 dollars)	.4	3.9	10.2	15.0	16.9
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.6	10.8	11.0
Difference	0	.1	.3	.5	.5
Potential gross national product (percent difference)	0	0	.1	.2	.4
Personal consumption expenditures difference (billions of 1978 dollars)	1.5	7.8	13.1	16.2	17.7
Personal disposable income difference (billions of 1978 dollars)	.8	3.8	9.0	13.1	14.1
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.7	5.2	5.0	4.6
Difference	0	−.2	−.3	−.4	−.4
Jobs difference (thousands)	22.0	180.0	408.0	524.0	508.0
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	5.1	4.4	3.7	4.5
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.7	6.0	5.6	5.6
New rate	5.6	5.8	6.3	6.0	5.9
Nonfinancial corporate gross internal funds (percent difference)	.6	2.3	3.7	4.5	4.5
Federal Government budget position (billions of dollars, NIA Basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−50.9	−26.2	−12.9	−8.6	1.9
Difference	−.8	3.2	7.3	10.9	12.3

Source: Data Resources, Inc.

TABLE A3.—MODIFIED KENNEDY PROPOSALS ON CAPITAL GAINS ACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	3.3	15.8	28.9	36.5	37.5
Nonresidential fixed investment difference (billions of 1978 dollars)	.7	5.1	12.6	18.4	20.9
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.7	10.9	11.1
Difference	0	.1	.4	.6	.6
Potential gross national product (percent difference)	0	0	.1	.3	.3
Personal consumption expenditures difference (billions of 1978 dollars)	2.7	10.3	16.3	20.1	21.5
Personal disposable income difference (billions of 1978 dollars)	2.5	6.3	11.7	16.3	17.1
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.7	5.1	4.9	4.5
Difference	0	−.2	−.4	−.5	−.5
Jobs difference (thousands)	44.0	245.0	513.0	659.0	659.0
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	5.2	4.5	3.8	4.5
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.7	6.0	5.6	5.6
New rate	5.6	5.8	6.4	6.1	6.0
Nonfinancial corporate gross internal funds (percent difference)	.9	2.9	4.6	5.4	5.5
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−51.3	−26.0	−10.5	−5.0	5.8
Difference	−1.2	3.4	9.8	14.4	16.3

Source: Data Resources, Inc.

TABLE A4.—REVENUE ACT OF 1978 WITHOUT THE ARCHER AMENDMENT NONACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	1.7	7.8	11.4	9.7	7.6
Nonresidential fixed investment difference (billions of 1978 dollars)	.3	2.6	5.9	7.4	6.9
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.5	10.6	10.7
Difference	0	.1	.2	.3	.2
Potential gross national product (percent difference)	0	0	.1	.1	.2
Personal consumption expenditures difference (billions of 1978 dollars)	1.3	5.1	6.9	6.3	6.0
Personal disposable income difference (billions of 1978 dollars)	1.1	3.0	4.6	4.6	3.7
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.8	5.4	5.3	4.9
Difference	0	−.1	−.2	−.1	−.1
Jobs difference (thousands)	22.0	122.0	215.0	179.0	97.0
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	4.9	4.1	3.4	4.4
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.6	6.0	5.6	5.6
New rate	5.6	5.8	6.2	5.8	5.6
Nonfinancial corporate gross internal funds (percent difference)	.4	1.4	1.9	1.8	1.6
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−50.5	−27.7	−16.9	−16.9	−9.5
Difference	−.4	1.7	3.4	2.6	.9

TABLE A5.—HANSEN-STEIGER BILL NONACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	2.0	11.7	18.0	15.8	11.8
Nonresidential fixed investment difference (billions of 1978 dollars)	.4	3.9	9.4	12.0	11.2
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.6	10.8	10.8
Difference	0	.1	.3	.4	.4
Potential gross national product (percent difference)	0	0	.1	.2	.4
Personal consumption expenditures difference (billions of 1978 dollars)	1.6	7.7	10.8	10.1	9.3
Personal disposable income difference (billions of 1978 dollars)	.9	3.7	6.9	7.3	5.8
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.7	5.3	5.2	4.9
Difference	0	−.2	−.3	−.2	−.1
Jobs difference (thousands)	24.0	180.0	335.0	279.0	117.0
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	5.1	4.2	3.4	4.3
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.7	6.0	5.6	5.6
New rate	5.6	5.8	6.2	5.8	5.7
Nonfinancial corporate gross internal funds (percent difference)	.7	2.2	3.2	3.1	2.6
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−50.8	−26.4	−15.6	−16.3	−10.2
Difference	−.7	3.1	4.6	3.2	.3

Source: Data Resources, Inc.

TABLE A6.—MODIFIED KENNEDY PROPOSALS ON CAPITAL GAINS NONACCOMMODATING MONETARY POLICY

	1979	1980	1981	1982	1983
Gross national product difference (billions of 1978 dollars)	3.4	- 15.1	21.9	19.2	14.2
Nonresidential fixed investment difference (billions of 1978 dollars)	0.7	5.0	11.6	14.6	13.8
Fixed nonresidentail investment as a percent of GNP:					
New ratio	9.8	10.2	10.7	10.8	10.9
Difference	0.0	0.1	0.4	0.5	0.5
Potential gross national product (percent difenerce)	0.0	0.0	0.1	0.3	0.3
Personal consumption expenditures difference (billions of 1978 dollars)	2.7	10.0	13.2	12.5	11.3
Personal disposable income difference (billions of 1978 dollars)	2.5	6.0	9.0	9.1	7.0
Unemployment rate (percent of labor force):					
Base rate	6.3	5.9	5.5	5.4	4.9
New rate	6.3	5.7	5.2	5.2	4.8
Difference	0.0	−0.2	−0.3	−0.2	−0.1
Jobs difference (thousands)	44	239	413	352	180
Rate of change in real GNP (percent):					
Base rate	3.9	4.6	3.9	3.5	4.5
New rate	4.0	5.2	4.2	3.3	4.2
Rate of change in implicit price deflator (percent):					
Base rate	5.6	5.7	6.0	5.6	5.6
New rate	5.6	5.8	5.3	5.9	5.7
Nonfinancial corporate gross internal funds (percent difference)	0.9	2.8	3.9	3.7	3.1
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−50.1	−29.4	−20.2	−19.5	−10.5
New level	−51.1	−26.3	−14.1	−14.8	−9.1
Difference	−1.1	3.1	6.2	4.7	1.4

Source: Data Resources, Inc.

APPENDIX B

STATISTICAL TABLES

This appendix contains 3 tables showing detailed simulation results indicated by Dr. Ture for: (1) the Revenue Act of 1978—H.R. 13511 without the inflation adjustment; (2) Senator Hansen's bill; and (3) President Kennedy's 1963 Tax Proposal with respect to capital gains.

TABLE B1.—REVENUE ACT OF 1978 WITHOUT THE INFLATION ADJUSTMENT

[Dollar amounts in constant 1977 dollars]

Increase or decrease (−) in	1979	1980	1981	1982	1983	Total 1979–83	1988
Employment (thousands of full-time equivalent employees)	60	06	60	70	70		100
Annual wage rate	$50	$60	$60	$60	$70		$100
Gross national product (billions):							
Total	8	9	11	11	12	$51	19
Business sector	6	7	7	8	9	37	13
Gross private domestic investment (billions):							
Total	5	6	9	12	15	47	11
Nonresidential	4	6	7	12	14	43	8
Consumption (billions)	3	2	2	(3)	(3)	1	8
Federal tax revenues: Net of feedback (billions)	0	0	0	0	0	0	1

Note.—The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the neares, 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays consumption, and Federal revenues are rounded to the nearest $1,000,000.

TABLE B2.—HANSEN-STEIGER BILL

[Dollar amounts in constant 1977 dollars]

Increase or decrease (−) in	1978	1979	1980	1981	1982	Total 1978–82	1987
Employment (thousands of full-time equivalent employees)	90	100	100	110	110		150
Annual wage rate	$80	$90	$90	$100	$110		$150
Gross national product (billions):							
Total	12	14	15	17	18	$76	27
Business sector	10	11	12	13	14	60	21
Gross private domestic investment (billions):							
Total	5	9	12	16	21	63	14
Nonresidential	6	8	11	14	17	56	11
Consumption (billions)	7	5	3	1	(3)	13	14
Federal tax revenues: Net of feedback (billions)	3	1	1	1	0	6	1

Notes.—The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

TABLE B3.—MODIFIED KENNEDY PROPOSALS ON CAPITAL GAINS[1]

[Dollar amounts in constant 1977 dollars]

Increase or decrease (−) in	1979	1980	1981	1982	1983	Total 1979–83	1988
Employment (thousands of full-time equivalent employees)	240	250	270	280	300		400
Annual wage rate	$210	$230	$250	$270	$280		$420
Gross national product (billions):							
Total	33	37	42	47	52	$211	81
Business sector	26	29	32	35	38	160	58
Gross private domestic investment (billions):							
Total	19	26	34	41	49	169	41
Nonresidential	17	25	32	40	46	158	36
Consumption (billions)	15	12	8	6	3	44	40
Federal tax revenues: Net of feedback (billions)	4	3	3	3	2	15	4

Notes.—The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year. Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change. Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1,000,000,000.

[1] The proposal consists of (a) increasing the proportion of net long-term capital gains excluded from income from the present 50 pct to 70 pct, (b) reducing the top individdaul marginal rate from the present 70 pct to 65 pct, with the marginal rate brackets specified in H.R. 13511, and (c) imposing an alternative minimum tax, such as that specified in H.R. 13511, at a rate of 15 pct. This table shows the effects of increasing the percent of net long-term capital gains excluded from income from the present 50 pct to 70 pct and the imposition of a 15 pct alternative minimum tax, assuming the H.R. 13511 Kennedy individual rate schedules were already in effect.

Tax Policy, Investment and Economic Growth

A Comparative Analysis of the Economic Effects of Alternative Tax Proposals Affecting Investment Income

Prepared by Securities Industry Association based on Econometric Studies by Data Resources, Inc.

Preface

Federal tax policy has a direct effect on the nation's economic growth. Tax reform proposals could have a significant impact on savings and investments, which are essential factors in determining the rate of that growth. Relying on the econometric model of the U.S. economy developed by Data Resources, Inc. (DRI), the Securities Industry Association (SIA) has conducted a detailed study of the impact of alternative tax proposals. The results of that study are contained in this report.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The acivities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Due to their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

DRI was founded in 1968 by Dr. Otto Eckstein with the objective of building an economic capability to assist clients, including governmental organizations as well as privately owned companies, in obtaining a sharper picture of the economic environment in which they operate. DRI economists have constructed one of the most comprehensive models of United States and international economic activity now available and the company manages the largest on-line data bank of economic information in the world.

This paper examines the relationship between economic growth and federal tax policy, discusses problems resulting from the lag in both physical and financial capital formation and, most importantly, analyzes the impact of nine selected tax proposals on the economy.

In reviewing tax proposals, the Administration and Congress have an opportunity to adopt positive tax policies which will promote investment, economic growth and employment. We hope that the analysis in the following pages will serve to illuminate the public debate on tax legislation.

SUMMARY

This paper is divided into four chapters, followed by statistical tables and other appendant materials. Chapter I outlines the importance of capital formation to economic growth and examines the nation's capital needs and the prospects for filling those needs. The chapter concludes that increased investment is essential to sustain eocnomic growth, create jobs and achieve national policy objectives concerning the environment, energy, housing and urban renewal.

Chapter II explores the relationship between tax policy and investment. Current tax policy discourages savings and investment through the imposition of multiple taxes on investment income at several levels. The result is a lower level of investment which is detrimental not only to investors, but to consumers, employees and corporations.

The level of investment undertaken by business is determined by the cost of capital as well as the expected return on investment. With the cost of equity capital rising steeply in recent years, corporations have had to rely inceraslngly on debt instruments. Corporate balance sheets deteriorated, with debt-equity ratios doubling and a shortening of the average life of corporate debt. Furthermore, small, young companies which, in the past, have been responsible for major gains in employeemnt are virtually unable to attract capital today.

While corporations' needs for capital have been increasing, an important source of capital has been shrinking. Chapter III traces the decline of direct individual equity ownership. Individual investors have faced not only the inflation and bear markets of recent years, but also a doubling of taxes on their gains from investment. For these and other reasons, the number of direct individual shareholders has dropped 18 percent since 1970, as five and one-half million individuals have left the stock market.

The analysis and accompanying charts in Chapter IV present considerable information concerning the estimated macroeconomic effects of nine different tax proposals compared to DRI's baseline forecast. These figures are estimates derived from the model, and indicate the direction and relative strength of the macroeconomic effects produced by each proposal. The summary table on the following page synthesizes the impact for each proposal using four indices. The first column shows the estimated net change in gross national product at 1978 price levels for the five-year period 1978–82. The second column shows the cumulative change in non-residential fixed investment (fixed business assets) in 1978 dollars. The third column indicates the change in the number of man-years of employment created or lost over the time period studied. The last column shows the five-year change in federal tax revenues in current dollars.

The summary table contains some striking information. The proposals studied reducing individual taxes have a stimulative effect on aggregate demand leading to a more robust economy and additional tax revenues. Conversely, those proposals which increase individual taxes slow down the economy, causing a reduction in tax revenues. In other words, restraint in government taxation and spending can lead to a larger economic pie for all including the government if an outlook of more than one or two years is taken.

Of the nine tax proposals analyzed in this study, the elimination of all taxes on capital gains (Proposal #4) produces particularly beneficial effects. This proposal shows the largest five-year gain in real GNP—nearly $200 billion. It also has the greatest impact on capital formation as fixed business assets increase by $81 billion. In addition, this proposal creates over 3 million additional man-years of employment from 1978 through 1982. At the same time, tax revenues increase $38 billion over the five-year period.

In contrast, the treatment of capital gains as ordiinary income even when combined with a reduction of the highest marginal tax rates to 50% and no limit on offsets against ordinary income for capital losses (Proposal #5), has a negative impact on the economy over the period 1978–82. Real GNP would be lowered by $48 billion, capital formation reduced by $43 billion, well over 450,000 man-years of employment would be lost and the federal government would lose over $5 billion in revenues.

Without providing for a full offset of all capital losses against ordinary income, the treatment of capital gains as ordinary income (Proposal #1) would be even more damaging to the economy. Real GNP would drop by $116 billion, capital formation would fall by $73 billion, more than 1,500,000 man-years of employment would be lost and the federal government would lose over $25 billion in tax revenues. Clearly, such a proposal would be harmful to the economy.

Dividend deductibility at the corporate level (Proposal #6) has a very positive impact on the economy. Of the nine proposals analyzed in Chapter IV, it has the second most favorable impact on real GNP, capital formation and the number of additional man-years of employment. However, this proposal has a high cost—federal tax revenues are reduced by $21 billion from 1978 through 1982.

The partial integration approach via the shareholder credit (Proposal #2) also results in a more robust economy. It has the third greatest positive impact on real GNP and the number of additional man-years of employment. This proposal has a smaller beneficial impact on capital formation than does dividend deductibility. However, partial integration would increase federal revenues by $18 billion from 1978 to 1982, while dividend deductability reduces tax revenues.

The so-called trade-off between eliminating the current treatment of capital gains and offering relief on the double taxation of dividends (Proposal #3) produces mixed results. The positive aspects of partial integration mitigate, but do not offset, the negative economic effects of increased capital gains taxes. While this proposal would increase real GNP, five of the other eight result in substantially greater growth. Four other proposals create more man-years of employment. Moreover, this proposal reduces capital formation by $32 billion and results in a loss of federal tax revenues of nearly $11 billion. In fact, three proposals outperform this one by all four standards—they produce more growth, more man-years of employment, more capital formation and incerase tax revenues instead of costing the government money.

Deferring taxes on capital gains through an investment rollover (Proposal #7), adjusting capital gains for inflation via a sliding scale (Proposal #8), and lowering the corporate tax rate from 48% to 46% (Proposal #9) are all similar in their impact on the economy, although the magnitude of their effects differ. All three lead to an increase in real GNP, a rise in capital formation and additional employment. Of the three, only the corporate tax cut reduces Federal revenues over the time period studied. Deferring the taxation of capital gains has the strongest positive impact on economic activity of these three proposals.

The basic conclusion drawn from al the simulations is that economic growth, employment and tax revenues will be increased by tax policies which promote capital mobility and encourage savings and investment.

SUMMARY TABLE

Tax proposal	Change in real gross national product, 1978–82 (billions of 1978 dollars)	Change in capital formation—fixed business assets—1978–82 (billions of 1978 dollars)	Change in man-years of employment 1978–82 (thousands)	Change in Federal Tax Revenues, 1978–82 (billions of current dollars)
1. Capital gains treated as ordinary income, with the maximum marginal rate on income, other than wages and salaries, set at 50 percent current loss treatment retained	−115	−73	−1, 529	−25
2. Partial integration via shareholder credit	144	26	2, 656	18
3. Combination of tax proposals No. 1 and No. 2	50	−32	1, 414	−11
4. No taxation of capital gains	199	81	3, 136	38
5. Tax proposal No. 1 with capital losses fully offsettable	−48	−43	−477	−7
6. Dividend deductibility at corporate level	171	49	2, 969	−21
7. Deferral of taxation for investment rollover	103	42	1, 629	19
8. Sliding scale adjustment	87	38	1, 283	28
9. Corporate tax cut from 48 percent to 46 percent	37	12	597	−7

CHAPTER ONE

ECONOMIC GROWTH—THE ROLE OF CAPITAL FORMATION

The April 1977 study paper Tax Policy and Capital Formation, prepared by the staff of the Joint Committee on Taxation, makes a most compelling case for increased capital formation:

"There are several reasons to be concerned about whether the United States will have an adequate amount of capital accumulation. First, there are several national goals whose fulfillment would require high levels of investment. These goals include the housing goals of the 1968 Housing Act, the environmental standards established in the Clean Water and Clean Air Acts, the goal of energy independence, the occupational health and safety standards for business, and the rebuilding of many parts of our large cities.

"Second, in the past decade there has been a significant increase in the rate of growth of the labor force—the people who either have jobs or are looking for them. Between 1966 and 1976, the labor force grew by 19 million workers, compared to an increase of 9 million between 1956 and 1966. This growth in the labor force has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment: therefore, the growth rate of the amount of plant and equipment available for each employee has declined significantly. This has reduced the growth of labor productivity—the amount produced per hour worked—and the decline in the growth rate of productivity has reduced the growth rate of real wages.

"A recent study by the Congressional Budget Office measures these disturbing trends in investment and productivity. It notes that the growth rate in the amount of private plant and equipment (excluding pollution control investments) declined from 4.3 percent per year in the period 1965–70 to 3.3 percent per year in 1970–75 and can be expected to decline further to 2.5 percent per year in the period 1975–77. The growth rate in the amount of such plant and equipment per worker fell from 2.6 percent in 1965–70 to 1.6 percent in 1970–75 and is expected to decline further to only 1.0 percent in 1975–77.

"According to the CBO study, the growth rate in worker productivity fell from 2.4 percent in 1965–70 to 1.0 percent in 1970–75. To some extent this resulted from unusually low productivity in the recession year of 1975, but inadequate investment in plant and equipment was also a major factor. The estimated contribution of increased plant and equipment to the increase in labor productivity fell from 0.9 percent per year in 1965–70 to 0.4 percent per year in 1970–75 and is estimated to be only 0.2 percent per year in 1975–77.

"Without major structural changes in the economy, the growth rate of real wages over the long run is determined primarily by the growth rate of productivity. The recent slowdown in the growth rate of the amount of plant and equipment per worker and the resultant slowdown in the growth rate of labor productivity, therefore, have contributed to the extremely sluggish growth in real wages in recent years. (Since 1969, realy hourly wages in private nonfarm employment have grown by only 5.2 percent, less than 1 percent per year.) To the extent that workers have responded to what they perceive to be an inadequate growth in real wages by demanding higher money wage rates, the rate of inflation has increased. More capital accumulation would raise real wage rates and could also reduce the rate of inflation.

"A third reason why it is desirable to increase investment is to forestall a repetition of the shortages which incurred in certain capital-intensity industries in 1973 and 1974 and which contributed to the high rate of inflation in those years. The affected industries included chemicals, steel and paper, along with other industries producing materials used as inputs by other industries. A high rate of investment in the next few years will help prevent the recurrence of this problem.

"Fourth, one dollar of additional investment in plant and equipment will increase gross national product by about 10 cents per year over and above what is needed to replace the assets as they wear out. To most Americans, this opportunity to increase future consumption by foregoing current consumption is attractive, which implies that more investment is desirable."

Adequacy of investment

The 1970's have been characterized by shortages of productive capacity in many basic industries and inflationary pressures. The nation has recently experi-

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enced the most rapid and sustained downturn in output and investment since the 1930's. Given this economic legacy, what is the outlook for the future?

A study prepared by the Bureau of Economic Analysis[1] (BEA) concluded that business fixed investment would have to average 12 percent of gross national product from 1975 to 1980 in order to ensure "a 1980 capital stock sufficient to meet the needs of a full employment economy and the requirements for pollution abatement and for decreasing dependence on foreign sources of petroleum."[2]

The share of GNP estimated by the BEA study needed for investment purposes considerably exceeds the percentage reached in any year since 1929. According to DRI's projections, that ratio is unlikely to be achieved in the foreseeable future.

It should not be impossible to achieve the share required by the BEA study. Consider, for example, the ratio of investment to GNP reached in other industrialized countries. During the period 1960–73, that ratio in the United States was less than one-half of that in Japan, and was below the corresponding percentages for West Germany, France, the U.K. and Italy. Moreover, U.S. productivity growth in manufacturing was less than one-third that of Japan, and well below that of the other nations mentioned above. By increasing the share of GNP devoted to investment, the differences in productivity growth between the U.S. and other industrialized nations should narrow.

Impact of additional investment

A higher level of investment would have the following desirable effects:

(i) Inflationary pressures will ease as the tradeoff between inflation and unemployment improves. Investment will tend to add to short-run inflationary pressures as its impact on aggregate demand outweighs its short-run impact on supply. After a few years, however, the supply effect will become paramount, leading to a relatively greater increase in supply than in demand. The essential advantage of tax policies which promote aggregate demand by stimulating investment rather than consumption is their impact on aggregate supply through increasing the capital stock and potential output.

(ii) The productive capacity of the economy will increase, permitting the private sector of the economy to consume more in the years ahead and allowing the public sector to pursue desirable social programs without putting undue strain on the capacity of the economy to pay for those programs.

(iii) More jobs will become available as a result of stimulating aggregate demand and increasing the capital stock, thereby raising the productivity of labor and the real incomes of those employed.

Given the economy's present and future large requirements for investment and the fact that projected levels of investment will apparently not reach the necessary amounts, government policies should encourage greater business investment and individual savings. The factors influencing the level of investment, including the crucial role of tax policy, are discussed in the following chapter.

CHAPTER TWO

TAX POLICY AND CAPITAL FORMATION

The promotion of capital formation is not an end in itself, but a means to an end. High levels of savings and investment are important for the benefits they generate to society and the economy. Private capital formation is crucial in determining changes in labor productivity, wage rates and employment opportunities. Additional capital formation is also needed to fulfill a growing population's demand for products, to meet the competitive pressures of world markets and to pay for additional and improved social services desired by society. To a substantial extent, postwar annual increases in measures of living standards have depended upon changes in the capital/labor ratio. Put another way, the labor force and economy suffer from a slowdown in capital formation and benefit from an increase in capital formation.

One recent article noted that although recent productivity gains have resembled the pattern of previous recoveries, they have not grown sufficiently to return to the postwar trend. This shortfall in productivity may be partly explained by inadequate capital formation.[2a] The same author wrote that the lagging recovery

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[1] U.S. Bureau of Economic Analysis. A Study of Fixed Capital Requirements of the U.S. Business Economy 1971–1980. Washington, 1975.

[2] Ibid : page 7.

[2a] Zickler, Joyce K., "Recent Labor Market Trends," Federal Reserve Bulletin, July, 1977.

in expenditures on plant and equipment dampened the recovery of employment in industries connected with the manufacture of capital goods, their suppliers as well as companies involved in nonresidential construction.[8]

Factors affecting capital formation

The level of investment undertaken by business depends on the expected return as well as the cost of the necessary funds. In recent years, the following factors, in addition to tax changes, have lowered investment by either reducing profitability or by increasing the cost of capital:

(i) Most observers agree that the financial position of business has deteriorated steadily over the last ten years. At best, even if the economic recovery continues, the financial condition of companies may improve over the near term, but remain fragile well into the future.

In the past, corporations relied on retained earnings and capital consumption allowances for about two-thirds of their financial requirements for investment. However, as inflationary forces took hold, the ratio of external to internal funds used for investment jumped to 55 percent by 1974. Over four-fifths of the increase in corporate long-term funds over the past decade stemmed from debt offerings, with the result being a doubling of corporate debt/equity ratios.

Accompanying the rise in the debt/equity ratio has been a reduction in the average maturity of corporate debt. The deterioration in corporate balance sheets forces financial managers to refinance more frequently and increases the potential exposure to tight credit conditions and possible financial failure. This, in turn, increases risk and the required expected return on capital before an investment will be undertaken.

(ii) New environmental and safety regulations have also served to lower the level of investment in two ways. First, such regulations require substantial additional outlays by business, thereby adding to production costs without any offsetting expectation of an increase in revenues. Second, changing regulations and differing interpretations of existing regulations increase uncertainty and risk. Therefore, the pre-tax rate of return must rise before new investments will be made.

(iii) Some of the decrease in the after-tax return on investment is attributed to an increase in taxes on "real" corporate profits. A period of high inflation lasting several years produces a distorted measure of taxable profits because revenues in current dollars, which now contain reduced real value, are compared with historical costs measured in undepreciated dollars. The liberalization in depreciation allowances and investment tax credits in recent years has not been sufficient to offset higher taxes relative to real corporate profits. Again, the result is a lower level of investment by business.

Tax burden on savings and investment and other factors

Although there are many economic and other factors influencing the levels of savings and investment, government tax policies are certainly among the most important variables affecting such decisions. Basically, any tax imposed upon the returns from savings and investment restrains such activities by driving a wedge between before and after-tax returns. Business firms are motivated to invest only in anticipation of increased revenues, reduced costs, and tax advantages whose net value exceeds the cost of the funds required for investment. More favorable tax treatment of the income from capital raises expected after-tax returns, and without any change in the cost of funds, would lead to additional investment.

A major obstacle faced by any tax proposal offering relief to savers and investors is the argument advanced by some people that government fiscal policies should redistribute income and wealth. Their view is often accompanied by assertions that the existing tax structure is riddled with provisions of special benefit to the more affluent individuals and companies. To compensate for these "loopholes," advocates of "tax reform" argue for heavier tax burdens on the returns from savings and investment. Unfortunately, such proposals often overlook the economic and social opportunities lost by increasing tax burdens on savings and investment.

Returns on investment cannot be decreased without considering the negative impact on consumers, employees and stockholders. Corporate taxes are reflected

[8] Ibid., p. 618.

in part by higher prices, lower wages and employment, and reduced returns on investment. Capital formation is inhibited; employment and productivity are reduced.

Everyone is affected by business taxes as a consumer. The majority of jobs in this country are provided by the private sector. Moreover, a large segment of the population has a vital stake in the economic performance of corporations through either direct share ownership or benefits provided by life insurance companies and pension funds with investments in common stock.

In the past, one serious impediment to tax legislation aimed at stimulating savings and investment has been a tendency to look only at the initial impact. Government revenue estimates of proposed tax changes have concentrated on initial impact rather than carefully evaluating how taxpayers will respond to changes and what the ultimate effects will be.

Reduced tax burdens on savings and investment should increase capital formation, employment and total income, thereby expanding the tax base. Actual tax revenues will be quite different from estimates calculated on the unrealistic assumption that taxpayers are unresponsive to change. Indeed, many proposals which initially lose tax revenues for the government are likely to produce revenue gains when investor behavior changes.

The present tax system is biased against savings because with few exceptions, taxes are imposed on income and again on income generated by savings from that original income. In contrast, the income tax falls only once on an individul's income used for consumption. The current structure of the U.S. income tax is not neutral as it increases the tax cost of savings relative to consumption.[4] One of the surest ways to promote increased capital formation is to shift the present tax structure away from favoring consumption towards a more neutral treatment of savings and investment.

For an income tax to be neutral with respect to savings and investment, it must either permit a deduction for the amount saved while assessing the yield on saving, or it must exempt the yield while including the amount saved in the taxable base. Even if the tax were imposed at a lower rate on either the amount saved or the yield, taxing both increases the cost of savings relative to consumption. The present bias favors consumption over savings and discriminates against capital formation.

As shown in Chapter IV, improving capital mobility through the tax system and encouraging savings and investment can improve economic growth to such an extent that both more investment and more consumption are achieved. Tax policies can be designed not merely to be neutral between consumption and investment, but to transfer idle resources to productive uses.

Impact on small business

Of the many factors influencing economic growth, none is more important than the level of capital investment. Economic vitality in this nation has paralleled the rise of dynamic new companies which were initially financed by individual investors. The present tax structure adversely affects small businesses in three ways.

First, a recent government study has noted the detrimental impact of higher capital gains taxes on new enterprises. Recent tax developments at all levels of government have sharply narrowed the gap between ordinary income and capital gains tax rates, reducing financial incentives for entrepreneurs.[5] The result is that the potential after-tax gain from a new venture may not be worth the risk and a relatively secure position with a large company may appear more attractive. The demand for venture capital is reduced.

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[4] A numerical example will illustrate this point. Assume that the cost of a certain basket of goods and services is $100. and that the same amount of money would purchase a bond paying 5 percent or $5 per year for ten years, with repayment of the $100 in principal at the end of the tenth year. Thus, the cost of $100 of current consumption is $5 a year for ten years, or $50. If an income tax is imposed at a flat rate of 50 percent, $200 of pre-tax income is needed to purchase the same basket of goods and services. The cost of consumption has doubled. However, $10 of pre-tax income is now needed to receive $5 of after-tax income. With yields unchanged, the bond holder now requires a $200 bond. But, to obtain a $200 bond now requires $400 of pre-tax income. Put simply, the 50 percent income tax quadrupled the cost of savings, and doubled the cost of savings relative to consumption.

[5] "The Role of New Technical Enterprises in the U.S. Economy", A Report of the Commerce Technical Advisory Board to the Secretary of Commerce, January, 1976, p. 6.

Second, like all enterprises, small businesses must compete in the capital market for funds. To the extent that the tax burden on savings leads to a contraction in the supply of capital, the result will be upward pressure on interest rates and possible rationing of capital funds. Small and new businesses, local governments and individuals may find themselves elbowed out of the capital markets. Funds for mortgages may also be curtailed.

Third, recent tax changes, by increasing the tax burden on those individuals who have traditionally provided seed money for new ventures, have made it extremely difficult for small companies to raise funds. Thus, both the supply of and demand for venture capital have fallen, leading to a decline in the number and value of public offerings by small business in recent years.[6] (See the following table.)

CAPITAL RAISED BY COMPANIES HAVING A NET WORTH OF UNDER $5,000,000

Year	Number of offerings	Funds raised (millions)
1969	548	$1,457.7
1970	209	383.7
1971	224	551.5
1972	418	918.2
1973	69	137.5
1974	8	13.1
1975	4	16.2

Source: "Report of the SBA Task Force on Venture and Equity for Small Business," U.S. Small Business Administration, January 1977, p. 13.

The same Advisory Board study mentioned earlier concluded that the young, innovative companies are responsible for larger percentage gains in employment than larger, more mature companies. The following figures were cited by the Commerce Department's Advisory Committee:

AVERAGE ANNUAL PERCENTAGE CHANGES FROM 1969-74

Type of company	Percentage change: Sales	Percentage change: Employment
Mature	+11.4	+0.6
Innovative	+13.2	+4.3
Young high technology	+42.5	+40.7

Source: "The Role of New Technical Enterprises in the U.S. Economy," a report of the Commerce Technical Advisory Board to the Secretary of Commerce, January 1976, p. 3.

The Advisory Board's report suggested that in large companies, innovation is viewed in terms of cost reduction. In small technically based enterprises, innovation is a way of life and leads to new products, processes, and employment opportunities.

Some observers have asserted that tax changes in areas such as investment credits and depreciation allowances have offset the negative tax factors affecting small business. Investment tax credits and liberalized depreciation allowances, while beneficial to some large corporations, are of little relative advantage to small business. The largest amounts and proportion of equipment in the productive process are used by large companies which tend to be more capital intensive. Furthermore, tax credits essentially benefit companies already earning profits. Small and new companies, which earn little or no taxable profits, receive minimum benefit from provisions lessening the tax liability on profits.

[6] It is recognized that inflation over this time period may have reduced the number of successful firms with a net worth of under $5 million measured in current dollars. However, inflation was also increasing the net worth in current dollars of companies at the very lowest range in the under $5 million category, possibly allowing them to reach a size where outside capital infusions became feasible. In any event, the plunge in both the number and value of funds raised for companies with a net worth of under $5 million is too dramatic to be explained merely by the impact of inflation on net worth measured in current dollars.

Recent tax changes, which have adversely affected the small company, have been equally harmful to the small or individual investor. The declining role of individual shareholders has important national implications which are spelled out in the following chapter.

Chapter Three

ROLE OF THE INDIVIDUAL INVESTOR IN CAPITAL FORMATION

Studies of capital formation usually concentrate on the importance of physical capital. However, just a few years ago, concern was raised over whether there would be ample financial capital available to support future requirements for additional housing, a cleaner environment, greater energy independence, a sufficient number of jobs and the prevention of capacity shortages in major basic industries. These goals have now been accepted as national objectives, and increase our capital requirements. Therefore, it is important to focus on people who, as investors, must provide the funds for capital investment. Unfortunately, the ranks of the individual suppliers of equity capital are shrinking. What has happened to the individual stockholder?

Financial assets of individuals have grown steadily over the thirty years since World War II, but individual stockholding, which increased even faster than the growth in individual financial assets from 1946 to 1970, has decreased since 1970. In 1946, individuals held $378 billion in financial assets, of which $103 billion or 27 percent was corporate stock. By 1970, individual financial assets grew to $1.9 trillion and stock ownership expanded to $737 billion or just under 40 percent of the total. However, although individual financial assets increased to $2.8 trillion by 1976, direct individual equity ownership fell slightly to $733 billion, or about 25 percent of total assets.

Moreover, the New York Stock Exchange reported in 1975 that, according to its census of shareholders, the number of individual stockholders fell for the first time since these surveys were started, dropping 5.6 million or 18.3 percent from 1970 to 1975. Today, there are only 25 million shareholders compared to 31 million in 1970.

Several factors contributed to the reduction in individual shareholders. Economic policies heightened uncertainty by shifting from stimulus to contraction and back again. Investors shifted away from equities towards safer, more liquid assets. Soaring inflation rates were a severe blow to all investments, including equities. The concern about recurring double-digit inflation rates continues, and individuals are reluctant to commit funds to the equity markets when yields on less risky investments are relatively attractive. Finally, the exodus of individual investors was accelerated by major changes in tax policy which increased capital gains taxes.

The SIA believes that after-tax yields affect the level of savings because the trade-off between consumption and savings is affected by expected after-tax yields. Certain studies argue that the level of savings is not affected by after-tax returns. However, even such studies stress the importance of net yield in determining the individual's selection among competing savings choices. For example, the study paper, Tax Policy and Capital Formation, cites studies showing that "an individual's choice between various assets is quite sensitive to the aftertax yields he expects to receive on the assets" and that "tax incentives for personal savings do not significantly affect the amount of such saving, but do affect its composition." The recent recovery in the level of personal savings has not prompted individuals to return to the stock market.

The U.S. tax system discourages direct individual investment in the equity markets in three principal ways:

(i) The tax system imposes levies on nominal, not real, gains on investment. For example, when assets appreciate in price over a period of years, the increase may simply reflect inflation. However, the proceeds from the sale of such assets are subject to capital gains taxation, even though the purchasing power of those proceeds may be no higher than that of the original investment. The investor faces a *real* increase in tax liability without any *real* improvement in the value of his investment. In other words, taxing nominal gains accruing over several years as ordinary income is inequitable.

(ii) The tax system does not adequately reflect the risks involved in capital investment. Increased taxation of capital gains since 1969 has reduced the return for individuals from investing directly in equities. Under the Tax Reform Act of 1969, the alternative tax of 25 percent on capital gains was limited to the first $50,000 of capital gains compared to no limitation prior to 1969; net long-term capital losses were allowed to offset ordinary income only to the extent of 50 percent of such losses with a $1,000 maximum; and capital gains were made a "tax preference item" subject to an additional 10 percent minimum tax. In 1976, the holding period for long-term capital gains was extended, the minimum tax was increased to 15 percent and provisions of the maximum tax were limited. All of these changes, together with the impact of inflation on capital gains, have increased the effective tax on capital gains and discouraged equity investment by individuals.

(iii) Double taxation of corporate dividends—taxation of corporate income at its source and then when distributed as dividends—decreases the after-tax return on equity investment, and serves as a further disincentive to individual stock investment.[7]

Proposals for reform

Recent discussions of tax reform have considered changes in capital gains for taxation. Some proposals would adjust capital gains for inflation. One mechanism to achieve this end—a sliding scale which reduced the portion of the gain subject to tax the longer an asset had been held—was narrowly defeated in the Senate during consideration of the Tax Reform Act of 1976. Another proposal would defer taxation if the gains were reinvested. Still other proposals would eliminate the distinction between capital gains and ordinary income and tax capital gains identically at ordinary rates. The current tax code provides deferral of capital gains taxation in certain instances when a taxpayer sells his home and buys a new residence.

Proposals addressing the double taxation of dividends would either allow corporations to deduct dividends, pass through a credit to shareholders for the corporate tax paid or eliminate corporate taxes.

While "full" integration would effectively eliminate the corporate income tax, the corporate tax might be used as a withholding mechanism for shareholders. Shareholders would incur a tax liability for a portion of the corporation's earnings equal to their proportion of ownership. Under such a proposal, the individual would incur a tax liability for income (corporate retained earnings) he has not received.

A more practical approach to eliminating double dividend taxation, in part, is "partial" integration or integration for dividends alone. Partial integration would result in a tax liability for the individual for the "grossed up" (pre-tax) corporate income attributable to dividends. Under this approach, the shareholder's income is increased by applying the ratio of dividends to after-tax income to the corporation's tax payment. At the same time, the shareholder receives a pro rata credit for the corporate tax attributable to the dividends.[8]

CHAPTER FOUR

THE MACROECONOMIC EFFECTS OF ALTERNATIVE TAX PROPOSALS

In this chapter, he effects of various tax proposals on the economy as a whole are analyzed. The 1977 version of DRI's quarterly econometric model[9] of the U.S. economy was used to simulate the effects of the following tax proposals:

1. Capital gains received are treated as ordinary income and the top marginal tax rate on income other than wages and salaries is reduced from 70 percent to 50 percent. Current treatment of capital losses is maintained.
2. Partial integration of the personal and corporate tax systems via the shareholder credit method, in which the individual taxpayer receives a credit for the corporate tax attributed to his dividend.
3. A combination of No. 1 and No. 2.
4. No taxation of capital gains received by individuals.
5. Policy No. 1, with capital losses allowed to be fully offset against ordinary income.
6. Partial integration of the corporate and personal income taxes by means of dividend deductibility at the corporate level. That is, corporations are permitted

[7] A detailed history of taxation of investment income appears in Appendix 'B'.

The following chapter examines the effects of these and other tax proposals on the economy.

[8] For a full description of this approach, see Tax Policy and Capital Formation, prepared by the staff of the Joint Committee on Taxation (April 4, 1977), p. 15.

[9] The term econometric model is explained in the Glossary.

to deduct dividends paid to individuals as a business expense in determining taxable income.

7. Deferal of taxation on capital gains when the funds are re-invested (deferral for investment *rollover*).

8. A sliding scale taxation formula for capital gains, with the proportion of the capital gain subject to tax declining from 50 percent if the asset were held for one year, to 10 percent if the asset were held for 21 or more years.

9. Reduction of the statutory corporate income tax rate from 48 percent to 46 percent.

Although some of the proposals set forth above are not under active consideration, they are incorporated into this report for the sake of completeness and comparison. This is particularly true for proposal No. 4.

METHODOLOGY

The effect on the economy of each of the tax proposals discussed is estimated for the period 1978–82, using DRI's quarterly econometric model. This model generates projections of some 800 variables, the more important of which include gross national product, investment in producers' durable equipment and nonresidential construction (fixed business assets), potential output, personal disposable income and consumption, unemployment and the rate of inflation. Results for all of these important variables are presented for each of the nine proposals studied.

In order to analyze the impact of the nine alternative tax proposals, it was necessary to impose two additional assumptions on the model. These assumptions relate to the dividend payout ratio—the fraction of after-tax profits paid out in dividends—and to the movement of stock market prices. Behavioral equations exist in the DRI model, both for dividends and the Standard and Poor index of common stock prices. Although these equations were constructed on the basis of data accumulated over a period of time, most of the tax proposals considered in this study were not in effect during that time span.

Therefore, specific assumptions regarding dividend payout ratios and stock market prices were developed for each tax proposal by the SIA in consultation with DRI.[10] The sensitivity of the results to changes in these assumptions is analyzed on page 40.

THE BASELINE FORECAST

DRI regularly generates forecasts of the economy through 1980. Details of these forecasts are published monthly by Data Resources. In addition to a control forecast, several alternatives are generated, including a markedly more pessimistic alternative (involving less real growth and more inflation), and a more optimistic alternative. For this paper, the August, 1977 control forecast has been extended through 1982 and envisions continued economic recovery, with growth in real gross national product averaging 4.2 percent annually over the period 1978–82. Unemployment falls to 5.1 percent of the labor force by the end of the period, while the rate of inflation (as measured by the implicit deflator for gross national product) averages 5.7 percent. Some "mid-course correction," associated primarily with movements in inventories, is foreseen for 1979.

In the analysis which follows, this forecast serves as the baseline, and the effects of the tax proposals are generally expressed in terms of deviations from these projections.

ANALYSIS OF THE PROPOSALS

The succeeding sections analyze each of the nine tax proposals. In each case, five effects are summarized: the total change in gross national product and capital formation (fixed business assets) over the five year period 1978–82 expressed in constant (1978) dollars; the change in employment expressed as the number of man-years created or lost over the time period studied; the largest single year increase or reduction in jobs as compared to the baseline forecast; and the cumulative change in federal tax revenues expressed in current dollars. Next, the assumptions about dividend payout ratios and the Standard and Poor's stock

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[10] Besides assumptions about dividend payout ratios and stock market prices, it was also necessary to impose assumptions about investors' willingness to realize capital gains. However, whereas changes in dividend payout ratios and stock market prices influence aggregate demand directly, the impact of changes in the willingness to realize gains is less direct in the DRI model. For this reason, we do not discuss the assumptions about the willingness to realize gains for each tax proposal and refer the reader instead to page 40 where the importance of the willingness to realize gains is referred to.

price index imposed on the model are discussed. Finally, the effects of the tax proposal on the economy, as simulated by the DRI econometric model, are discussed in more detail under a series of headings relating to real gross national product, investment in producers' durable equipment and nonresidential construction (fixed business assets), consumption and personal income, employment, the Federal budget and inflation. Charts are included showing the effect of the proposal, year by year, on gross national product, fixed business assets, employment and the Federal budget.

The economy tends to respond in a cyclical fashion to any policy change. We have assumed that monetary policy will be accommodating, with the Federal Reserve adjusting the money supply sufficiently to ensure that interest rates remain close to the levels projected in the DRI baseline forecast. The cyclical pattern of economic adjustments to tax changes would be considerably accentuated if it were assumed that monetary policy would be nonaccommodating and interest rates allowed to vary from those projected in the baseline forecast. Some discussion of the effects of assuming nonaccommodating monetary policy appears below on pages 40–41. Regardless of the assumption with respect to monetary policy, the effect of any tax proposal on gross national product will have slackened considerably by 1982 because of cyclical factors. Statistical details on the simulations are provided in Tables 1–9 of Appendix 'A'; Tables 10–18 provide results for the same tax proposals assuming monetary policy does not keep interest rates at levels projected in the baseline forecast.

Many of the short-run effects of the alternative tax proposals analyzed herein are due to their impact on aggregate demand. That is, policies which involve tax cuts increase GNP through stimulating consumption and/or investment.

The advantages of stimulating aggregate demand through tax reforms aimed at making investment more attractive are basically longer term. In particular, there is an increase in the capital stock and therefore the nation's production and employment potentials, as compared to scenarios in which aggregate demand is stimulated by increased private or government consumption.

In the short-run, the fiscal stimulus provided by any tax reduction would be accompanied by increased inflationary pressures. Again, the advantages of proposals aimed at stimulating investment in lieu of consumption are long-term. Through their impact on aggregate supply, proposals leading to increased investment allow the economy to provide for future demands with little or no inflation.

Most of those long-term effects become important after 1982. Unfortunately, the DRI baseline forecast in this study does not extend beyond 1982. The beneficial impact on aggregate supply however, can be inferred from the discussion of "Investment and Fixed Business Assets," and "Employment and Unemployment" included below for each alternative tax proposal.

Tax Proposal Number 1

CAPITAL GAINS TREATED AS ORDINARY INCOME, WITH THE MAXIMUM MARGINAL RATE ON INCOME, OTHER THAN WAGES AND SALARIES, SET AT 50 PERCENT (COMPARED WITH THE PRESENT 70 PERCENT). CURRENT TREATMENT OF CAPITAL LOSSES IS MAINTAINED

Economic Variable:	*Change from baseline forecast*
Gross national product (1978–82)	reduced $115 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	reduced $73 billion (1978 dollars)
Man-years of employment (1978–82)	reduced 1,500,000
Jobs (peak effect)	reduced 480,000 (1981)
Federal tax revenues (1978–82)	reduced $25 billion (current dollars)

Behavioral Assumptions[11]

This proposal can be expected to affect the dividend payout ratio substantially. For dividend recipients with a marginal tax rate over 50 percent, the value of after-tax dividends would increase, in some cases by as much as 66⅔ percent. On the other hand, the attractiveness of capital gains (and hence retained earnings) is substantially reduced. Thus, it was assumed that this tax proposal would raise the dividend payout ratio by 20 percent, with this rise taking place smoothly over

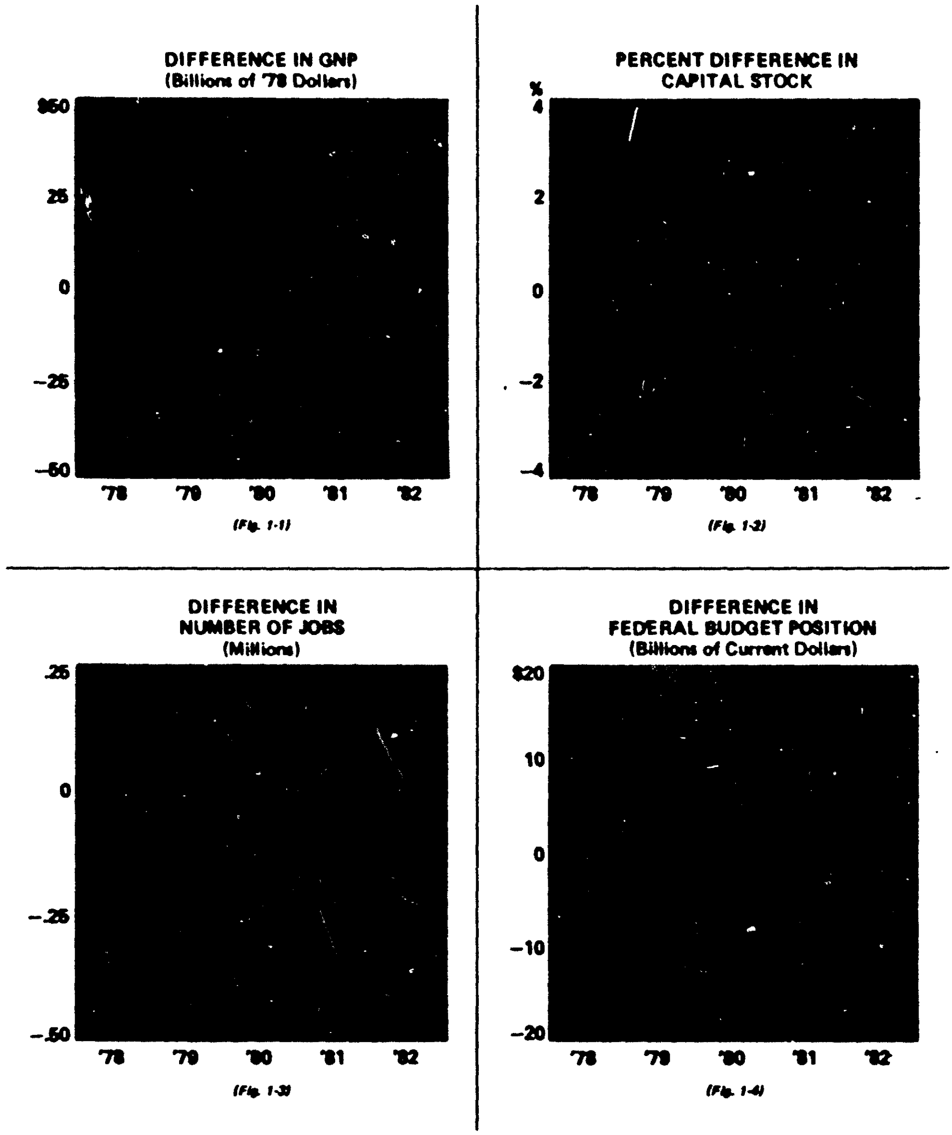
[11] The importance of the behavioral assumptions is discussed on pages 40–41.

the first three years of the change. However, taxing capital gains as ordinary income, primarily because of the decrease in the value of unrealized appreciation, would reduce stock prices despite a higher payout ratio. A 10 percent drop in the S & P index was assumed with this change taking place smoothly over the first five quarters after the tax proposal is implemented.[12]

Empirical results

These assumptions, when run through the DRI model, produce the macroeconomic results shown in Table 1 of Appendix 'A' and in Charts 1.1–1.4 (see the following page). Effects on key variables are as follows:

PROPOSAL – 1



Gross National Product.—Economic activity is reduced below the baseline by $3.3 million[13] in 1978, and by as much as $39 billion in 1982 or 1.6 percent of output in that year. The cumulative loss over the five-year period 1978–1982 is almost $115 billion.

Investment and Fixed Business Assets.—The necessity to pay out increased dividends has a sharp downward impact on funds retained by corporations. In

[12] For each of the nine tax proposals, any assumptions concerning a change in the dividend payout ratio and S & P index were introduced over the same time periods as in Proposal #1.

[13] All magnitudes presented in dollars, with the exception of tax receipts and Federal budget estimates, are discussed in real terms—that is, corrected for price changes. Except where otherwise stated, these values are expressed at expected 1978 prices. Federal tax revenues and budget estimates are expressed in current dollars.

addition, as a result of the weaker economy, expected returns on investment decline. Finally, the decrease in stock prices reflects an increase in the cost of capital to corporations. All of these factors reduce investment. Each year, the value of investment is below the baseline by ever increasing amounts, and the reduction in 1982 is over 10 percent below the baseline projection of $269.6 billion for that year.

The effect of this slump in investment is to reduce the economy's fixed business assets by over 3 percent relative to the baseline in 1982. Moreover, potential output is lower in 1982 by almost 0.6 percent or $15 billion.

Employment and Unemployment.—The reduction in economic activity causes the unemployment rate to rise above the baseline forecast by four-tenths of a percentage point in 1981. However, the unemployment rate tells less than the full story. Whenever the rate of growth of the economy slackens, the labor force increases less than it otherwise would. Thus, the unemployment rate does not fully measure the decline in employment. The model results project the loss of over 1,500,000 man-years of employment from 1978–1982.

Personal Income and Consumption.—The increased payout of dividends serves to cushion somewhat the effects of the increase in capital gains taxes and the lower level of employment. The peak effect on real personal income occurs in 1982 when it is $9.3 billion below the baseline. Consumption is reduced by a somewhat greater amount due to the impact of the lower stock market on the value of equity holdings. In 1982, consumption is $12 billion below the baseline with the cumulative loss over the five years being $37 billion.

Corporate Balance Sheets.—As mentioned earlier when discussiong the impact on investment, the cash flow [14] of corporations is severely impacted because dividend payments are considerably higher. In addition, the weaker economy lowers after-tax profits. As a result, the cash flow of non-financial corporations is reduced by over 10 percent by 1982, and the debt-equity ratio [15] rises dramatically to the point where it has jumped over 20 percent in 1982 as compared to the baseline forecast.

Tax Receipts and the Deficit.[16]—Tax receipts are increased in 1978 by $2.4 billion. After 1978, the feedback from the weakened economy is such that tax receipts are actually below the baseline and by ever increasing amounts. The net loss of revenue to the Federal government over five years, measured in current dollars (as distinct from constant 1978 dollars), amounts to $25 billion. The effect on the deficit is very similar. In the baseline forecast, the budget is almost balanced by 1982. The model predicts that the budget will still be in deficit by $12 billion in 1982, if Proposal No. 1 is enacted.

Inflation.—The weaker economy reduces the average annual rate of inflation over the five year period by 0.2 percentage point. As discussed on page 20, because the projections do not extend beyond 1982, the long-run impact of different measures on aggregate supply cannot be analyzed thoroughly. Thus, the impact of a policy on aggregate demand is more immediate and will actually determine whether the projected inflation rates are above or below those contained in the baseline forecast. Tax proposals weakening the economy lower the inflation rate; proposals strengthening the economy project higher rates of inflation. This phenomenon occurs in all nine simulations discussed in our study and should be considered in assessing the impact of a specific proposal on inflation.

TAX PROPOSAL NO. 2

PARTIAL INTEGRATION VIA THE SHAREHOLDER-CREDIT METHOD

Economic variable:	*Change from baseline forecast*
Gross national product (1978–82)	increased $145 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment	increased $26 billion (1978 dollars)
Man-years of employment (1978–82)	increased 2,700,000
Jobs (peak effect)	increased 760,000 (1981)
Federal tax revenues (1978–82)	increased $18 billion (current dollars)

[14] This concept is defined in the Glossary.
[15] This concept is defined in the Glossary.
[16] Tax receipts are measured on an accrual basis. The deficit is measured on a National Income and Product Accounts basis.

Under this proposal, the individual taxpayer receives a tax credit for the corporate taxes attributed to his dividend receipts. An effective corporate tax rate of 29 percent was used in computing the credit and tax-exempt shareholders were assumed ineligible for the credit.

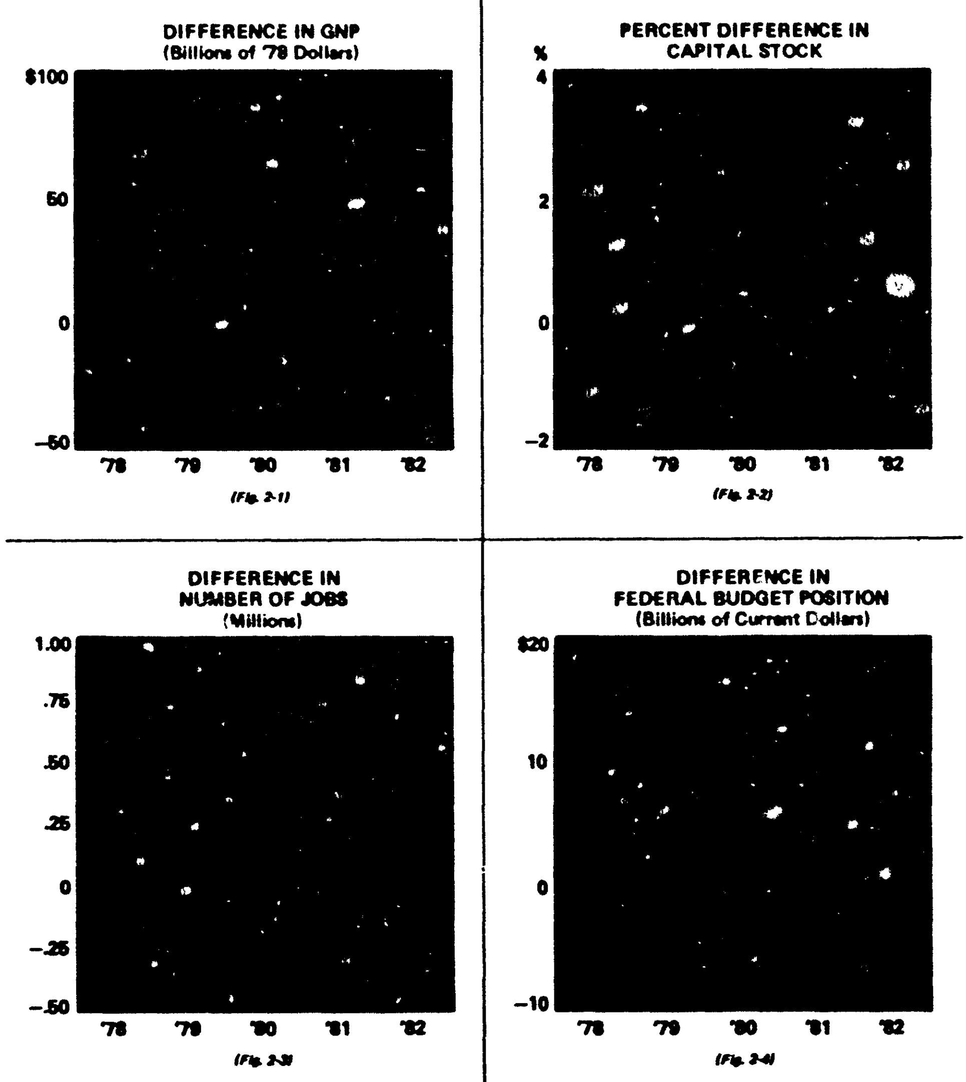
Behavioral assumptions

Implementation of this proposal can be expected to increase the dividend payout ratio. Since the value of after-tax dividends has increased, investors will place additional emphasis on dividend receipts. In this regard, we have assumed an increase in the dividend payout ratio of 10 percent. The stock market is assumed to rise 10 percent also reflecting the increased after-tax value of dividends received.

Empirical results

The effects of this tax cut are contained in Table 2 of Appendix 'A' and in Charts 2.1–2.4 (see the following page).

PROPOSAL – 2



Gross National Product.—Over the first three years, the annual rate of growth in GNP is increased by about 0.5 percent. After 1980, there is some flattening out in the growth rate, for reasons discussed on page 20. The peak effect occurs in 1981 when real GNP is $39 billion (1.6 percent) above the baseline. Over the five-year period, the net gain in output is over $140 billion.

Investment and fixed business assets.—Despite the increase in the dividend payout ratio, higher stock market prices and the robust economy predominate, indicating higher expected returns from and lower capital costs of investment. The simulation shows a substantial increase in corporate investment by 3 percent above the baseline ($7.7 billion in 1978 dollars) in 1981. The increased investment raises fixed business assets by a little over 1 percent by the end of 1982, along with an increase in potential output of about 0.3 percent or about $7 billion.

Employment and unemployment.—The stronger economy drives the unemployment rate down by 0.6 percentage point in 1981. This reduction will lower the projected unemployment rate for that year below 5 percent, and the number of additional man-years of employment created approaches 2,700,000 over the five year period.

Personal Income and Consumption.—Personal income increases because of the tax credit, the increased payout of dividends, and the stronger economy. The rate of growth of personal disposable income is higher by 0.4 percentage point in each of the first three years; by 1982, disposable income is $32 billion greater than the baseline. The impact on consumption is slightly more because of the wealth effect [17] from higher stock market prices. (Increases in wealth resulting from price changes in existing assets are not included in personal income as defined income as defined in the natilonal income and product accounts.) By 1982, consumption is $33 billion above the baseline; over the five-year period, the cumulative increase comes to $116 billion.

Corporate balance sheets.—By 1982, the cash flow of corporations is improved marginally, as is the debt-equity ratio. The improvement in corporate cash flow would be more pronounced if not for the higher dividend payout ratio.

Tax receipts and the deficit.—Federal government tax receipts are lower by $4.8 billion in 1978. Tax receipts are only marginally below the baseline in 1979, and are sharply above it in 1980–82. As a result, the Federal budget shows a surplus for 1981 and 1982.

Inflation.—The stronger economy increases the annual rate of inflation by about 0.3 percentage point over the period studied for the reasons explained on page 20.

TAX PROPOSAL NUMBER 3

A COMBINATION OF TAX PROPOSAL NUMBER 1 AND TAX PROPOSAL NUMBER 2. THAT IS, CAPITAL GAINS ARE TREATED AS ORDINARY INCOME, THE TOP MARGINAL TAX RATE ON INCOME OTHER THAN WAGES AND SALARIES IS CUT TO 50 PERCENT, AND TAXPAYERS RECEIVE A CREDIT FOR THE SHARE OF TAX PAID BY CORPORATIONS ATTRIBUTABLE TO DIVIDENDS. CURRENT TREATMENT OF CAPITAL LOSSES IS RETAINED.

Economic variable:	*Change from baseline forecast*
Gross National Product (1978–82)	increased $50 billion (1978 dollars)
Capital Formation 1978–82) (fixed business investment)	reduced $32 billion (1978 dollars)
Man-Years of Employment (1978–82)	increased 1,400,000
Jobs (peak effect)	increased 400,000 (1982)
Federal Tax Revenues (1978–82)	reduced $11 billion (current dollars)

Behavioral assumptions

Implementation of this propsal is assumed to lead to an increase in the dividend payout ratio of 25 percent by 1980. This change is less than the combined increases assumed for Proposals Number 1 and Number 2 because of the belief that, beyond a certain point, corporations will increase their resistance to paying out additional dividends. The interaction of Proposals Number 1 and Number 2 will have conflicting effects on stock prices. For this reason, it is difficult to project whether overall stock prices will rise or fall. Thus, no additional change in the S & P index is assumed beyond that contained in the baseline forecast.

The effect of combining the shareholder credit for dividends with the taxation of capital gains as ordinary income is to increase the attractiveness of dividends relative to capital gains. Consumption rather than investment is stimulated by this proposal as compared to other proposals stimulating aggregate demand (Proposals Number 2, 4, 6, 7, 8, and 9). Proposal Number 3 is a clear example of

[17] This term is explained in the Glossary.

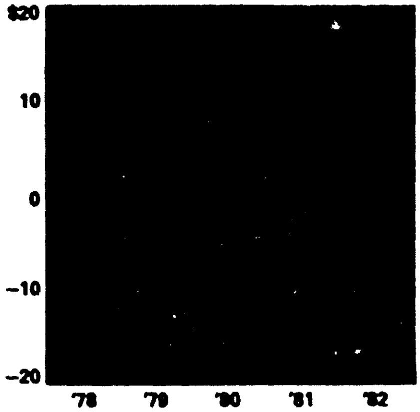
the differential impact on capital formation of applying fiscal stimulus via consumption rather than investment.

Empirical results

The effects of this proposal are shown in Table 3 of Appendix "A" and Charts 3.1–3.4.

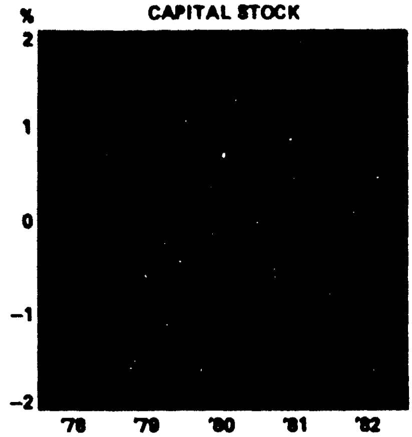
PROPOSAL – 3

DIFFERENCE IN GNP
(Billions of '78 Dollars)



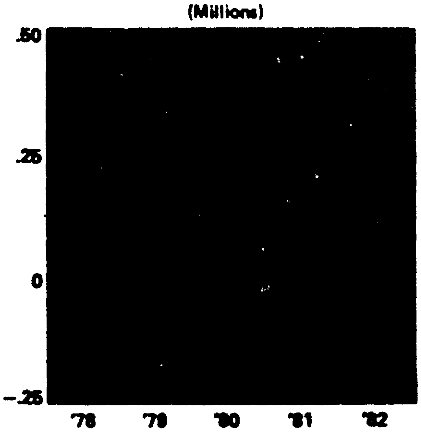
(Fig. 3-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



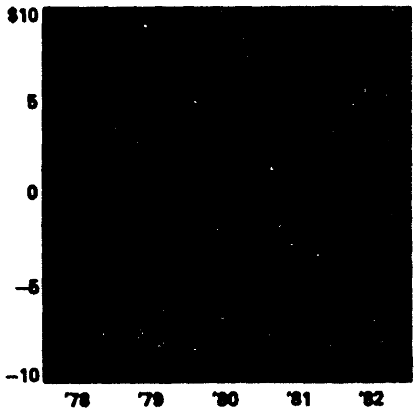
(Fig. 3-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 3-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 3-4)

Gross national product.—The annual rate of growth of real GNP increases by an average of 0.2 percentage point the first three years. In 1980, output is $14 billion (0.6 percent) above the baseline. The cumulative gain over the five-year period is almost $50 billion.

Investment and fixed business assets.—The effects of this proposal differ from the others studied in that, in this case, gross national product and fixed non-residential investment move in opposite directions. These conflicting trends occur primarily because the pressure to pay more dividends leaves companies with less funds to invest and this fact outweighs the higher expected return on investment resulting from the stronger economy. Moreover, the cost of capital is up sharply. In 1982, nonresidential fixed investment is $14 billion (5.1 percent) below the baseline. As a result, total fixed business assets are lower by 1.4 percent by the end of 1982, and potential output is reduced 0.3 percent, or about $7.5 billion.

Employment and unemployment.—The unemployment rate is reduced by 0.3 percentage point from 1980 through 1982. Over 1,400,000 man-years of employment are created through 1982.

Personal Income and consumption.—Individuals benefit directly from the tax cut, the increased payout of dividends and the stronger economy. The peak effect on disposable income is in 1981, when it is higher by $25 billion (1.5 percent). By 1982, consumption is $24 billion above the baseline, with the cumulative effect over the five-year period being $83 billion.

Corporate balance sheets.—The cash flow of corporations is reduced by over 7 percent and the debt-equity ratio is over 20 percent higher by 1982. Only Proposal Number 1 is more damaging to the financial structure of corporations.

Tax receipts and the deficit.—Federal government tax receipts are below the baseline by $2.8 billion in 1978. In subsequent years, tax receipts are, on average, lowered by $2 billion per year. The net reduction in tax revenues over the five-year period is nearly $11 billion. The cumulative effect on the budget is to increase the deficit by nearly $9 billion.

Inflation.—The stronger economy causes the annual rate of inflation to be higher by an average of 0.1 percentage point as explained fully on page 20.

TAX PROPOSAL NO. 4

NO TAXATION OF CAPITAL GAINS

Economic variable:	*Change from baseline forecast*
Gross national product (1978–82)	Increased $199 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	Increased $81 billion (1978 dollars)
Man-years of employment (1978–82)	Increased 3,100,000
Jobs (peak effect)	Increased 910,000 (1981)
Federal tax revenues (1978–82)	Increased $38 billion (current dollars)

Behavioral assumptions

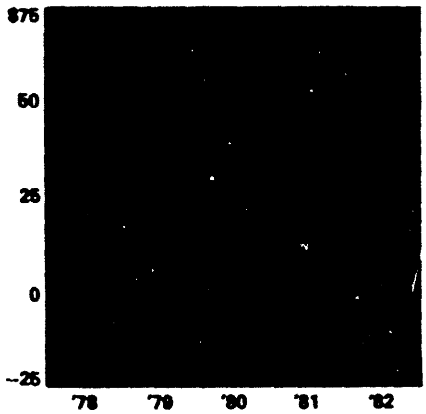
This proposal, included for purposes of comparison, differs sharply from the first three studied in that it increases the relative attractiveness of capital gains (and hence of retained earnings). For this reason, it is assumed that enactment of this proposal *decreases* the dividend payout ratio by 10 percent by the year 1980. The stock market would be expected to react very positively to this measure; a rise of 20 percent in the S & P index is assumed.

Empirical results

Full details of the estimated effects of this proposal are shown in Table 4 of Appendix "A" and in the accompanying Charts 4.1–4.4 (see the following page).

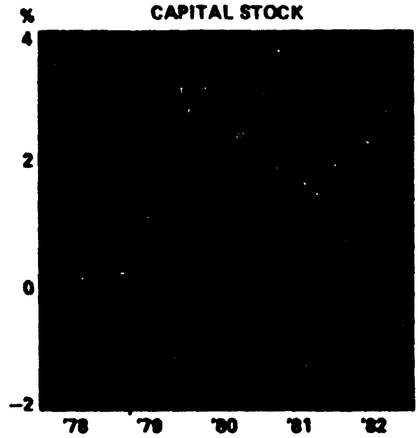
PROPOSAL – 4

DIFFERENCE IN GNP
(Billions of '78 Dollars)



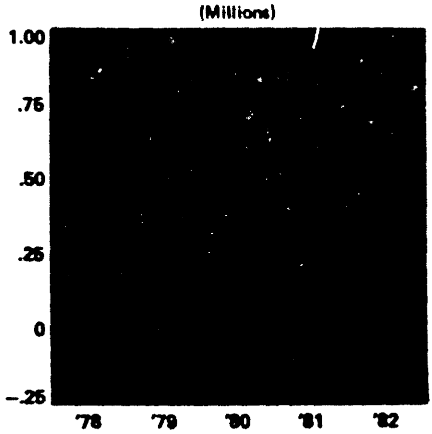
(Fig. 4-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



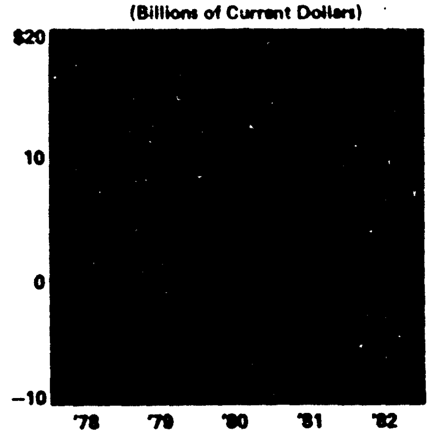
(Fig. 4-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 4-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 4-4)

Gross national product.—The elimination of taxes on capital gains has the largest impact on gross national product of all the proposals studied. In 1981, output is $56 billion (2.4 percent) above the baseline. In 1982, the impact on output is even larger ($57.4 billion), though in percentage terms, it is slightly smaller (2.3 percent). Over the five year period, the total gain in economic activity is no less than $200 billion.

Investment and fixed business assets.—The elimination of taxation on capital gains encourages the realization of gains and stimulates the flow of savings into new investment opportunities. An assumed sharp rise in stock market prices lowers the cost of obtaining funds via external financing. These factors, together with the feedback effects of the overall stronger economy, raise investment in fixed business assets by as much as $28 billion in 1982 (10.5 percent above the baseline). For the period 1978–82, cumulative investment is $81 billion higher. The result is a rise of 3.5 percent in fixed business assets by 1982, accompanied by an increase in potential output of 0.7 percent or $17 billion.

Employment and unemployment.—The unemployment rate is reduced by 0.7 percentage point in both 1980 and 1981. The effect is somewhat less in 1982 because the impact on demand under this tax proposal has leveled off, while the economy's capacity to supply goods and services is still increasing. Thus, there is a slight fall in capacity utilization in 1982, causing the unemployment rate to stabilize at about 4.5 percent. Through 1982, more than 3,000,000 man-years of employment are created relative to the baseline under this proposal.

Personal income and consumption.—By 1982, personal incomes are higher than the baseline by $30 billion and consumption is increased by a slightly greater amount. Over the five-year period, consumption is $116 billion higher as a result of this proposal.

Corporate balance sheets.—The peak effect is in 1981, when the cash flow of nonfinancial corporations is raised by about 10 percent, while the debt-equity ratio falls by a similar percentage.

Federal tax receipts and the deficit.—Tax receipts are lower by $5.1 billion in 1978. In subsequent years, receipts are higher than in the baseline. The net gain in revenues for the five-year period is about $38 billion. The effect on the deficit is similar—there is an annual surplus of between $10 and $15 billion for 1981–82.

Inflation.—The stronger economy causes the rate of inflation to be higher by an average of 0.4 percentage point per year.

TAX PROPOSAL NO. 5

CAPITAL GAINS TAXED AS ORDINARY INCOME, WITH CAPITAL LOSSES FULLY OFFSET AGAINST OTHER INCOME. THE TOP MARGINAL TAX RATE IS REDUCED FROM 70 PERCENT TO 50 PERCENT ON ALL INCOME SOURCES

Economic Variable:	*Change from baseline forecast*
Gross national product (1978–82)	Reduced $48 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	Reduced $43 billion (1978 dollars)
Man-years of employment (1978–82)	Reduced 480,000
Jobs (peak effect)	Reduced 150,000 (1980)
Federal tax revenues (1978–82)	Reduced $7 billion (current dollars)

Behavioral assumptions

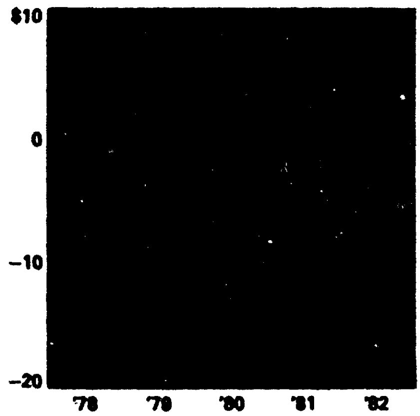
The provision for capital losses mitigates, to some extent, the effects on both the dividend payout ratio and the stock market of taxing capital gains as ordinary income. The dividend payout ratio is assumed to rise by 15 percent relative to the baseline (compared wtih the figure of 20 percent for Tax Proposal No. 1). The S & P index is assumed to fall by 5 percent.

Empirical results

Full details of the estimated effects of this measure are shown in Table 5 of Appendix "A" and in the accompanying Charts 5.1–5.4 (see the following page). The negative effects on the economy are considerably less than if current restrictions on capital loss offsets were in effect, as was the case in Proposal No. 1.

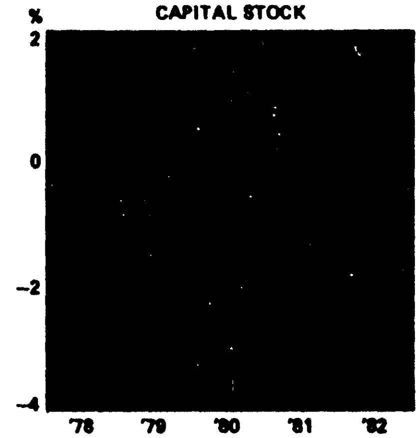
PROPOSAL – 5

DIFFERENCE IN GNP
(Billions of '78 Dollars)



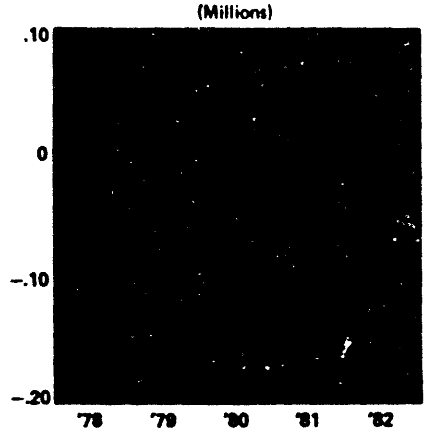
(Fig. 5-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



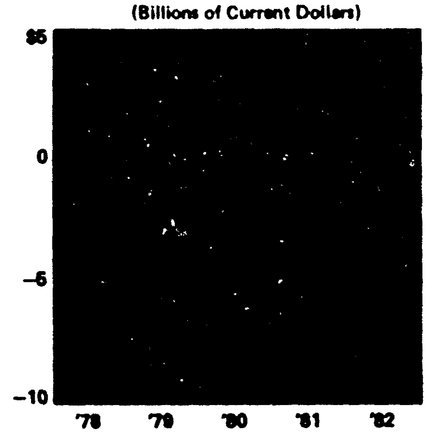
(Fig. 5-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 5-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 5-4)

Gross National Product.—By 1982, gross national product is about $16 billion (0.6 percent) below the baseline. The cumulative loss in economic activity over the five-year period is almost $48 billion.

Investment and fixed business assets.—Investment is reduced by increased dividend payments, lower after-tax profits, and the higher capital costs due to a fall in stock prices. Business investment is down by $16 billion in 1982, and is responsible for the decline in GNP that year. For the five-year period, investment is down $42 billion. The stock of fixed business assets is lower than in the baseline by about 2 percent at the end of 1982, and potential output is reduced by 0.4 percent or $10 billion.

Employment and unemployment.—The unemployment rate is higher throughout the five-year period by an average of 0.1 percentage point. Through 1982, the number of man-years of employment is reduced by almost 500,000 under this tax proposal.

Personal income and consumption.—The impact on personal income and consumption is relatively small because increased dividend receipts cushion the effects of the weaker economy. Nevertheless, any increase in consumption resulting from this proposal is at the expense of investment.

Corporate balance sheets.—The cash flow of corporations is reduced by 7 percent while the debt-equity ratio increases over 14 percent by 1982.

Tax receipts and the deficit.—Federal tax receipts are above the baseline by $1.3 billion in 1978, and remain marginally higher in 1979. In succeeding years, the weaker economy reduces tax receipts by progressively greater amounts relative to the baseline. By 1982, receipts are $4 billion below the baseline, and the deficit is $3 billion greater. Over the five-year period, the federal government will lose nearly $7 billion in tax revenues.

Inflation.—The weaker economy reduces the rate of inflation an average of 0.1 percentage point per year as explained more fully on page 20.

Tax Proposal No. 6

DIVIDEND DEDUCTIBILITY AT THE CORPORATE LEVEL

Economic variable:	*Change from baseline forecast*
Gross national product (1978–82)	increased $171 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	increased $49 billion (1978 dollars)
Man-years of employment (1978–82)	increased 3,000,000
Jobs (peak effect)	increased 920,000 (1982)
Federal tax revenues (1978–82)	reduced $21 billion (current dollars)

Behavioral assumption

The deductibility of dividends at the corporate level should increase dividend payments. It is assumed that dividends to tax-exempt institutions would not be deductible from corporate income. An increase of 10 percent is assumed for both the dividend payout ratio and stock prices.

Although the assumption made concerning the dividend payout ratio, stock market prices and the realization of capital gains is the same for the shareholder credit approach and dividend deductibility, these alternatives differ sharply in their impact on the economy. The major reason for this difference is that the former represents a smaller tax reduction than the latter.[16] As used in this study, if the shareholder credit approach were implemented, $100 in dividend payments cost the government $24.50. In contrast, if dividend deductibility were enacted, $100 of dividend payments cost the government $45 in tax revenues. Since more dollars remain in the private sector, dividend deductibility has a larger stimulatory impact on the economy. Another distinction between the two is that with the shareholder credit, individuals are the initial beneficiaries of the tax relief. Under dividend deductibility, corporations receive the initial tax benefit.

Empirical results

The effects of this proposal are shown in Table 6 of Appendix "A" and in the accompanying Charts 6.1–6.4 (see the following page).

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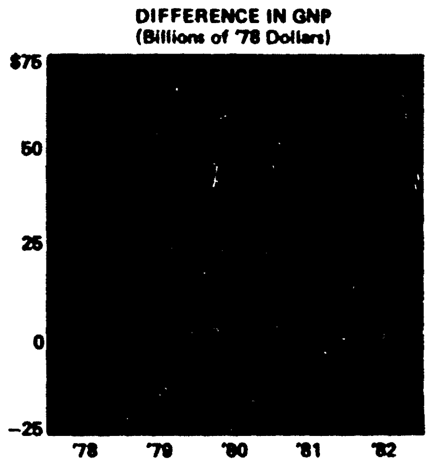
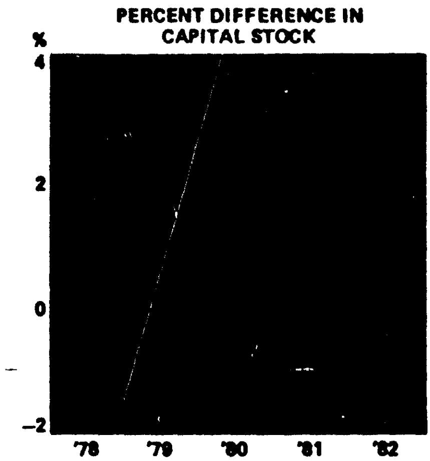
[16] The basic reason for this is that the shareholder credit is applied at the average corporate tax rate of 29 percent, which is further reduced to 24.5 percent as a result of the grossing up feature. In comparison, dividend deductibility is applied at a marginal corporate rate of 45 percent.

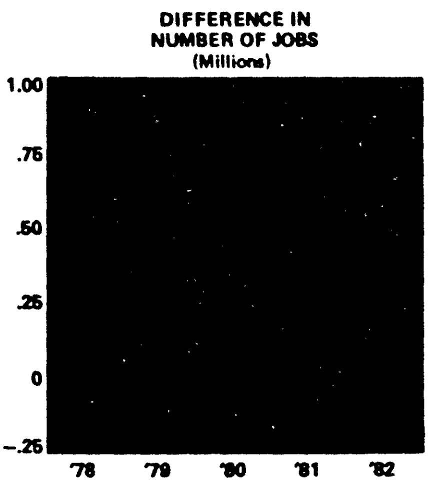
PROPOSAL – 6



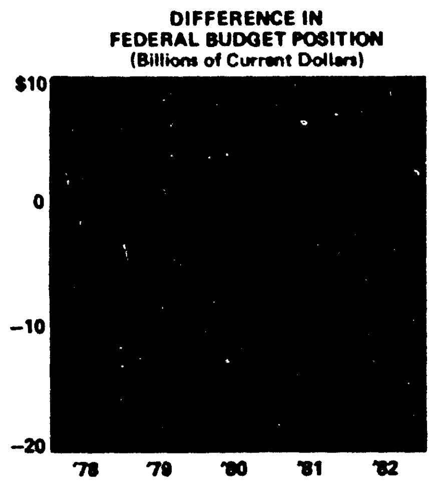
(Fig. 6-1)



(Fig. 6-2)



(Fig. 6-3)



(Fig. 6-4)

Gross national product.—Dividend deductibility at the corporate level has a smaller first-year effect on gross national product than other tax cut proposals. In 1982, GNP under this proposal soars by over $53 billion. The total gain in economic activity over the five-year period is $171 billion.

Investment and fixed business assets.—This proposal has a potent effect on business investment. In 1982 alone, investment increases by $16 billion (5.9 percent), reflecting increased corporate cash flow and the lower after-tax cost of capital. The total increase in investment over the five-year period, over $48 billion, is sufficient to raise the economy's aggregate supply of fixed business assets by a little over 2 percent, and potential output by 0.4 percent or $10 billion.

Employment and unemployment.—The unemployment rate is reduced by 0.7 percentage point in both 1981 and 1982. Through 1982, the number of man-years of employment increases by almost 3,000,000.

Personal income and consumption.—Personal income increases by $37 billion in 1982, due to higher dividend payments and the stronger economy. Consumption is $39 billion above the baseline in that year. The effect on consumption is greater than on income because of the wealth effect resulting from higher stock market prices. The total gain in consumption over the period 1978–82 is $116 billion.

Corporate balance sheets.—The cash flow position of corporations is improved considerably by this proposal. The maximum change in corporate cash flow is an increase of 12.5 percent in 1981, while the debt-equity ratio is lowered by almost 15 percent in 1980. This ratio is still lower than the baseline by almost 12 percent in 1982.

Tax receipts and the deficit.—Federal tax revenues are reduced $12.7 billion in 1978. Significant tax decreases totalling $10.7 billion also occur in the next two years. As a result, the Federal deficit is increased in each year of the period 1978 to 1982. The total increase in the deficit over the five-year period is $29 billion.

Inflation.—The strengthened economy raises the rate of inflation by an average of 0.3 percentage point per year as explained more fully on page 20.

TAX PROPOSAL NUMBER 7

DEFERRAL OF TAXATION ON CAPITAL GAINS FOR INEVSTMENT "ROLLOVER"

Economic variable:	*Change from baseline forecast*
Grass national product (1987–82)	Increased $103 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	Increased $42 billion (1978 dollars)
Man-years of employment (1978–82)	Increased 1,600,000
Jobs (peak effect)	Increased 470,000 (1981)
Federal tax revenues (1978–82)	Increased $19 billion (current dollars)

Under this proposal, taxes on gains realized from the sale of stock could be deferred if the gains were reinvested. The proposal loosely parallels deferral of capital gains when a homeowner sells his home and purchases a replacement home under specified conditions. No specific assumptions were made regarding definitions or the time period within which reinvestment would have to occur.

Behavioral assumptions

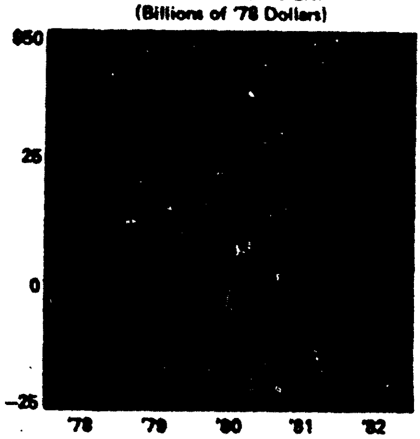
The impact on both the dividend payout ratio and stock market prices is assumed to be half that of Proposal No. 4. The dividend payout ratio is five percent below the baseline projection, while stock market prices rise by 10 percent.

Empirical results

The effects of this measure are shown in detail in Table 7 of Appendix "A" and in Charts 7.1-7.4 (see the following page).

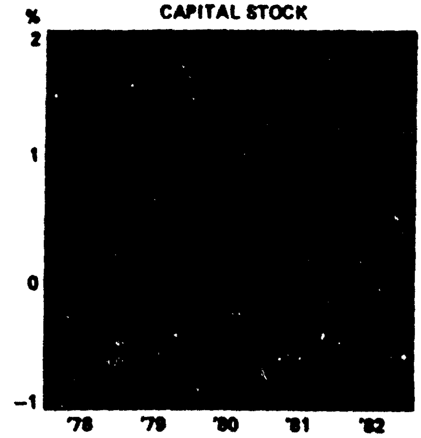
PROPOSAL – 7

DIFFERENCE IN GNP
(Billions of '78 Dollars)



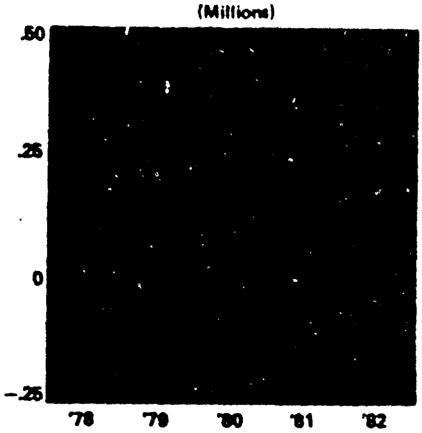
(Fig. 7-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



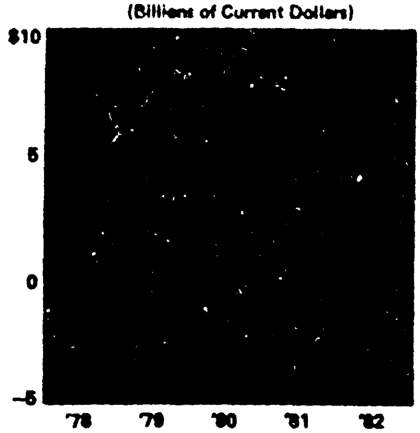
(Fig. 7-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 7-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 7-4)

Gross national product.—Gross national product is raised by over $31 billion (1.3 percent) in 1982, with the cumulative gain in economic activity for the five-year period being slightly over $103 billion.

Investment and fixed business assets.—Business investment is increased $14.5 billion or 5.4 percent above the baseline in 1982 because of a more robust economy, high retained earnings and the lower cost of capital. The cumulative increase in investment from 1978 to 1982 is over $41 billion—sufficient to raise the economy's fixed business assets 1.8 percent and potential output 0.4 percent, or $10 billion.

Employment and unemployment.—The unemployment rate is reduced by 0.3 percentage point in the period 1980–1982 and the number of man-years of employment is higher by over 1,500,000 for the five-year period.

Personal income and consumption.—Personal income is raised by almost $17 billion in 1982. Consumption is up by $18 billion in 1982 and by $60 billion over the five-year period. In other words, there is a substantial increase in capital formation—$42 billion-relative to the increase in consumption. This is also true for Proposals No. 8 and No. 9.

Corporate Balance Sheets.—The cash flow of corporations under this tax proposal is improved 5 percent in each year of the period 1980 to 1982. The debt-equity ratio is lowered by about 6 percent over the same period.

Tax receipts and the deficit.—Tax receipts are $2.6 billion below the baseline in 1978, and above the baseline by ever-increasing amounts for the rest of the period. By 1982, tax receipts have increased $9 billion. The deficit will temporarily increase in 1978, but will be reduced in 1979 and 1980. Indeed, under this proposal, the budget is in surplus in 1981 and 1982.

Inflation.—The rate of inflation is increased by an average of 0.2 percentage point per year as a consequence of the stronger economy as explained more fully on page 20.

TAX PROPOSAL NO. 8

SLIDING SCALE ADJUSTMENT FOR INFLATION

Economic variable:	*Change from baseline forecast*
Gross national product (1978–82)	Increased $87 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	Increased $38 billion (1978 dollars)
Man-years of employment (1978–82)	Increased 1,300,000
Jobs (peak effect)	Increased 390,000 (1981)
Federal tax revenues (1978–82)	Increased $28 billion (current dollars)

Under this proposal, the portion of a capital gain subject to taxation declines according to the length of time the asset has been held. For assets sold after being held for one year, the proportion of the gain subject to tax is 50 percent. This proportion decreases by 2 percent per year, reaching a minimum of 10 percent for assets held 21 years or more. This proposal would not alter existing law with regard to tax rates, the minimum tax or the maximum tax.

Behavioral assumptions

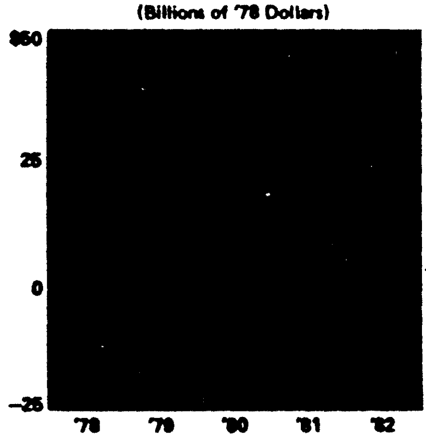
This proposal assumes a decrease of five percent in the dividend payout ratio. Furthermore, stock prices are assumed to rise by 10 percent. These assumptions are the same as for Proposal No. 7 but the tax reduction is less than in Proposal No. 7.

Empirical results

Estimated effects of this proposal are shown in detail in Table 8 of Appendix "A" and in Charts 8.1–8.4 (see the following page).

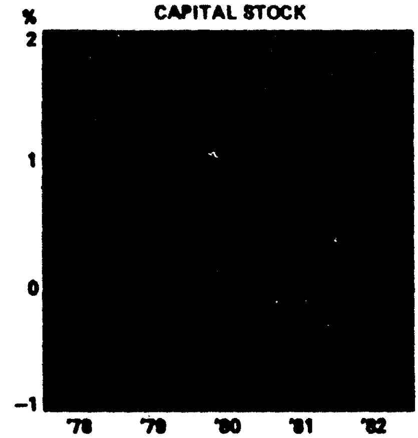
PROPOSAL – 8

DIFFERENCE IN GNP
(Billions of '78 Dollars)



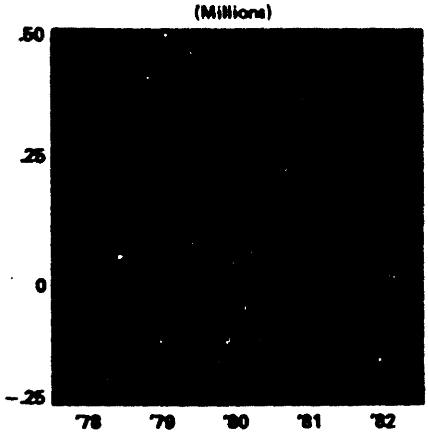
(Fig. 8-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



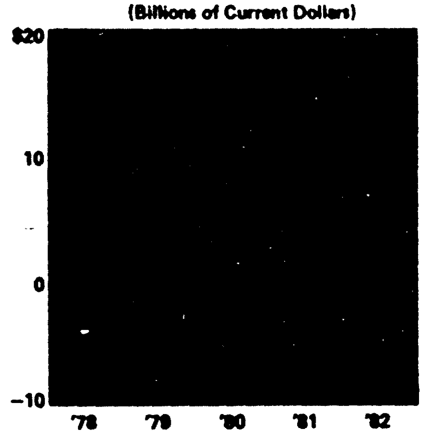
(Fig. 8-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 8-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 8-4)

Gross national product.—Gross national product is higher by $28 billion (1.2 percent) in 1982 with a total growth in output over the five-year period of $87 billion.

Investment and fixed business assets.—Business investment increases by $13.5 billion in 1982 and almost $38 billion for the five-year period as a result of the stronger economy, greater cash flow and the lower cost of capital. The capital stock and potential output rise by 1.7 percent and 0.3 percentage point, respectively, by 1982.

Employment and unemployment.—The unemployment rate is lowered by 0.3 percentage point in each year from 1980 to 1982, and over 1,200,000 additional man-years of employment are created from 1978 to 1982.

Personal income and consumption.—Personal income expands by $12 billion (0.7 percent) in 1982, and consumption is increased by almost $15 billion. Over the five-year period, consumption is higher by $45 billion.

Corporate balance sheets.—The increase in after-tax profits resulting from the stronger economy and reduced dividend payments (due to the greater attraction of capital gains), enhance corporate cash flow by a maximum of almost 5 percent in 1981. The maximum change in the debt-equity ratio is a decrease by over 6 percent relative to the baseline in 1982.

Tax receipts and the deficit.—Tax receipts decrease by $0.7 billion in 1978. In succeeding years, federal tax receipts are increased by as much as $11 billion in 1982. The effect on the deficit is similar. Budget surpluses for 1981 and 1982 total $16 billion.

Inflation.—The stronger economy causes the rate of inflation to rise relative to the baseline by slightly more than 0.1 percentage point per year as explained more fully on page 20.

Tax Proposal Number 9

STATUTORY CORPORATE TAX RATE CUT 48 PERCENT TO 46 PERCENT

Economic variable	*Change from baseline forecast*
Gross national product (1978–82)	Increased $37 billion (1978 dollars)
Capital formation (1978–82) (fixed business investment)	Increased $12 billion (1978 dollars)
Man-years of employment (1978–82)	Increased 600,000
Jobs (peak effect)	Increased 190,000 (1982)
Federal tax revenues (1978–82)	Decreased $7 billion (current dollars)

Behavioral assumptions

A change in corporate tax rates should not affect dividend payout ratios,[19] so no change is assumed. However, a cut in corporate tax rates should lead to higher stock prices. It was assumed that under this proposal, stock prices would increase 2.5 percent. This percentage is consistent with the 10 percent increase in stock prices assumed in Proposal #6 (dividends deductible at the corporate level).

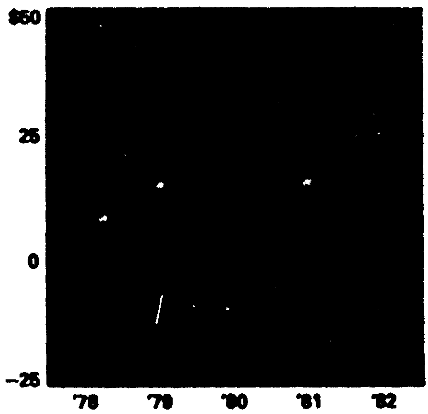
Empricial results

Estimated effects of lowering the statutory corporate income tax rate to 46 percent are shown in Table 9 of Appendix "A" and in Charts 9.1–9.4 (see the following page).

[19] See, e.g., John A. Brittain, "Corporate Dividend Policy" (The Brookings Institution, Washington, D.C., 1966), particularly pp. 111–114.

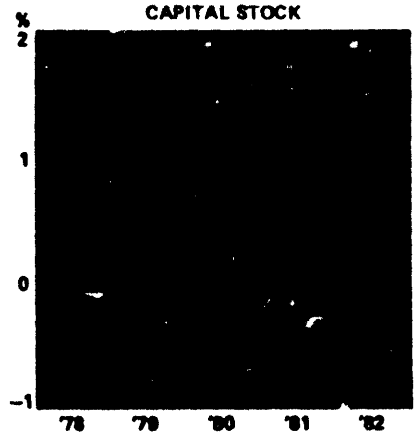
PROPOSAL – 9

DIFFERENCE IN GNP
(Billions of '78 Dollars)



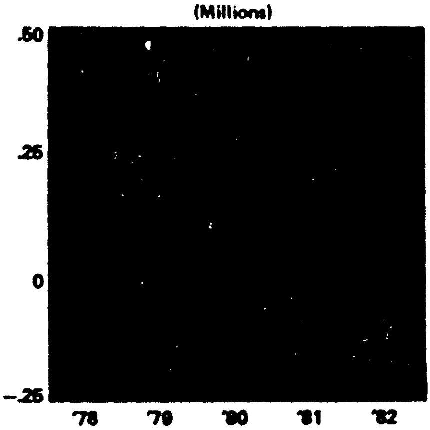
(Fig. 9-1)

PERCENT DIFFERENCE IN
CAPITAL STOCK



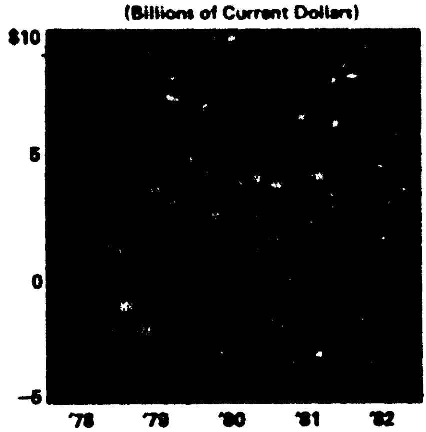
(Fig. 9-2)

DIFFERENCE IN
NUMBER OF JOBS
(Millions)



(Fig. 9-3)

DIFFERENCE IN
FEDERAL BUDGET POSITION
(Billions of Current Dollars)



(Fig. 9-4)

Gross national product.—The peak effect on gross national product occurs in 1982, when output is over $12 billion higher. The total gain over the five-year period is $37 billion.

Investment and fixed business assets.—Business investment is higher by about $3.5 billion in 1982, and by $11.5 billion for the five-year period as the after-tax return on investment increases. As a result, the capital stock and potential output are higher by 0.5 percent and 0.1 percent, respectively.

Employment and unemployment.—From 1979 to 1982, the unemployment rate is lower by 0.1 percentage point each year. The number of man years of employment increases by almost 600,000 through 1982.

Personal income and consumption.—Personal income is higher by over $7 billion in 1982. Almost all of the increase in income stems from the stronger economy. Consumption is higher by over $7 billion in 1982, and almost $22 billion over the five-year period.

Corporate balance sheets.—A corporate tax cut will have an immediate impact on corporate cash flow. The peak effect is in 1980, when corporate cash flow is increased by almost 3 percent, while the debt-equity ratio is reduced by almost 4.5 percent.

Tax receipts and the deficit.—Tax receipts are down for each year of the period. In 1978, the revenue loss is $3.4 billion. The total loss of tax revenue from 1978–

1982 is just over $7 billion, and the cumulative effect on the deficit is almost $9 billion.

Inflation.—There is no noticeable change in the rate of inflation from that in the baseline.

BASES FOR THE ASSUMPTIONS

This section discusses the likelihood that substantive tax changes will have significant effects on the dividend payout ratio and on stock market prices. The assumption of accommodating monetary policy is also discussed.

Support for the assumption that the dividend payout ratio could change markedly under alternate tax policies is drawn from:

(i) The U.S. experience in the period 1936–38, when an additional graduated tax was imposed on retained earnings. (during the two years in which this surtax on undistributed profits was applicable, dividend distributions were estimated to be one-third greater than they would have been).

(ii) Quantitative studies using United Kingdom data, most particularly by Feldstein and by King.[20]

(iii) Brittain's analysis of corporate dividend policy,[21] where he demonstrates that payout ratios are sensitive to changes in tax parameters.

Based on these factors, the assumed changes in dividend payout ratios appear to be reasonable. Indeed, they may be conservative.

A change in the dividend payout ratio makes little difference on the impact of a specific tax proposal on gross national product. A rise in the ratio, other things remaining constant, tends initially to have a small stimulative effect as consumption rises by more than corporate investment falls. After two years, the stimulus has nearly disappeared.

The assumption concerning stock market prices is critical from the point of view of the macroeconomic effects of any policy change. While there is little empirical work concerning the impact of tax changes on equity prices, the assumptions used in this study are conservative. Substantial movements in stock market prices can be expected to influence consumption materially. In addition, the impact of equity prices on the cost of capital implies that fluctuations in stock market prices will affect investment decisions to a substantial degree. Thus, both investment and consumption may be expected to move in the same direction as equity prices.

Some economists argue that correlations between stock market prices and other economic variables are not evidence of causality but rather reflect the independent but contemporaneous influence of such factors as monetary policy. In other words, correlation is not evidence of casuality. But, recent empirical work has suggested that the decline in the stock market from 1973–75 was a major cause of the severity of the recession experienced in those years.[22] In the DRI model, the economy is quite sensitive to movements in stock market prices. A 10 percent rise in the market index, other things constant, leads eventually to a 0.6 percent rise in gross national product, a 2.8 percent increase in investment in fixed business assets and a 0.7 percent jump in consumption.

The willingness to realize capital gains will change under alternative tax proposals. For example, higher taxes on capital gains should lead to a lower realization of such gains and less tax revenue than if the propensity to realize gains were to remain constant. Changes in tax payments as reflected in the DRI model lead to fluctuations in income, consumption, investment and other important economic variables. Thus, the inclination to realize capital gains also determines in part the projections for each of the tax proposals.

The assumptions made concerning the dividend payout ratio, the reaction to stock market prices and the change in the willingness to realize capital gains, are repeated on the following page for ease of reference.

Another assumption made in this paper, as reflected in Tables 1–9 of Appendix "A", is that monetary policy will accommodate changes in tax policy. The DRI model allows interest rates to rise to some extent in the case of a growing

[20] See particularly M. S. Feldstein, "Corporate Taxation and Dividend Behavior," Review of Economic Studies, 37 (1970), pp. 57–62 and M. S. King, "Corporate Taxation and Dividend Behavior—A Comment," Review of Economic Studies, 38 (1971), pp. 377–380.

[21] John A. Brittain, op. cit., particularly pp. 77–87.

[22] See Frederic S. Mishkin, "What Depressed the Consumer? The Household Balance Sheet and the 1973–75 Recession," Brookings Papers on Economic Activity, 1977 1, pp. 123–174. See also, Barry Bosworth, "The Stock Market and the Economy," Brookings Papers on Economic Activity, 1975: 2, pp. 257–290. Both of these works contain references to other important material in this area.

economy and fall in a contracting economy. In the case of a proposal which has an expansionary impact on the economy, it is assumed that the Federal Reserve will increase the money supply to keep interest rates consistent with the baseline forecast. In all of the proposals analyzed, interest rates were kept consistent with the baseline forecast.

The estimated effects of each proposal, assuming nonaccommodating monetary policy, are shown in Tables 10–18. The change in gross national product and other variables following any non-corporate tax reduction is both smaller and more cyclical under an assumption of nonaccommodating policy because higher interest rates reduce several categories of demand, particularly residential construction and, to a lesser extent, other investment.[23]

KEY ASSUMPTIONS MADE

Policy	Percent change from baseline in: Divident pay-out ratio	Stock market index	Realization of capital gains
1. Capital gains as ordinary income	+20	−10	−10
2. Partial integration via shareholder credit	+10	+10	0
3. Tax policy No. 1 and No. 2	+25	0	−10
4. No taxation capital gains	−10	+20	+20
5. Tax policy No. 1 plus full writeoff of losses	+15	−5	[1] −10 [2] +20
6. Deductibility of dividends at corporate level	+10	+10	0
7. Deferral of taxation for rollover	−5	+10	+10
8. Sliding-scale adjustment	−5	+10	+10
9. Corporate tax cut	0	+2.5	0

[1] Gains.
[2] Losses.

Both accommodating and nonaccommodating monetary policy, as here defined, can be viewed as polar extremes. In fact, if the stimulative tax policy were enacted, the Federal Reserve would probably adopt an accommodating policy, but would allow a slight rise in interest rates above the baseline forecast if inflation accelerated.

The overall effects of most expansionary policies are dampened considerably in the case of nonaccommodating monetary policy. For example, the total increase in gross national product for 1978–82, assuming no taxation of capital gains, is reduced from $200 billion to $130 billion. However, the relative impact of the proposals is not significantly altered (see the Table on the following page). The conclusion that tax policies increasing the mobility of capital and incentives to save and invest (reducing capital gains taxes, for example) can be more effective than the traditional policies used in expanding consumption and the economy (reducing the corporate tax rate, for example) is not dependent on the assumptions made about monetary policy.

SUMMARY TABLE

Tax proposal	Change in real gross national product, 1978–82 (billions of 1978 dollars)		Change in capital formation—fixed business assets—1978–82 (billions of 1978 dollars)		Change in man-years of employment, 1978–82 (thousands)		Change in Federal tax revenues, 1978–82 (billions of current dollars)	
	A	NA	A	NA	A	NA	A	NA
1. Capital gains treated as ordinary income, with the maximum marginal rate on income, other than wages and salaries, set at 50 percent. Current loss treatment retained	−115	−74	−73	−64	−1,529	−849	−25	−7
2. Partial integration via shareholder credit	144	94	26	32	2,656	1,690	18	−7
3. Combination of tax proposals No. 1 and 2	50	36	−32	−37	1,414	1,146	−11	−4
4. No taxation of capital gains	199	128	81	65	3,136	1,910	38	4
5. Tax proposal No. 1 with capital losses fully offsettable	−48	−34	−43	−40	−477	−267	−7	−1
6. Dividend deductibility at corporate level	171	168	49	51	2,969	2,981	−21	−22
7. Deferral of taxation for investment rollover	103	68	42	33	1,629	1,032	19	3
8. Sliding scale adjustment	87	52	38	30	1,283	668	28	12
9. Corporate tax cut from 48 to 46 percent	37	40	12	13	597	411	−7	−6

A = Accommodating. NA = Nonaccommodating.

[23] The worsening of the deficit late in the period in the case of a tax cut (see, for example, Table 11) is due primarily to the Federal Government paying out more in interest as a result of the higher rates.

Appendix A—Statistical Tables

This appendix contains 18 tables, showing detailed simulation results for the nine tax proposals studied. Tables 1–9 show results under the assumption that monetary policy is accommodating, while Tables 10–18 contain results assuming nonaccommodating monetary policy. Table 19 is DRI's baseline forecast as of August, 1977.

TABLE 1.—CAPITAL GAINS TAXED AS ORDINARY INCOME—TOP TAX RATE CUT TO 50 PERCENT—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	−3.3	−12.7	−25.1	−34.8	−39.0
Nonresidential fixed investment difference (billions of 1978 dollars)	−.8	−6.0	−15.0	−23.2	−27.9
Fixed nonresidential investment as a percentage of GNP:					
New ratio	9.7	9.8	9.7	9.7	9.7
Difference	0	−.2	−.5	−.8	−.9
Potential gross national product (percent difference)	0	−.1	−.2	−.4	−.6
Personal consumption expenditures difference (billions of 1978 dollars)	−2.3	−6.0	−7.6	−9.5	−11.8
Personal disposable income difference (billions of 1978 dollars)	−2.1	−2.0	−2.6	−6.3	−9.3
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.6	6.3	5.8	5.5
Difference	0	.2	.3	.4	.3
Man-years of employment difference (thousands)	−46.0	−197.0	−387.0	−481.0	−418.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	4.7	2.5	4.6	3.9	3.7
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.5	5.3	5.6	5.2
Nonfinancial corporate gross internal funds (percent difference)	−2.1	−5.5	−8.8	−10.2	−10.8
Federal government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−43.6	−44.7	−25.2	−13.9	−12.3
Difference	2.5	−.4	−5.3	−10.0	−11.7

Source: Data Resources, Inc.

TABLE 2.—PARTIAL INTEGRATION BY THE SHAREHOLDER CREDIT METHOD—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	9.2	22.6	35.1	39.3	38.3
Nonresidential fixed investment difference (billions of 1978 dollars)	.9	3.3	6.2	7.7	7.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	10.0	10.3	10.6	10.8
Difference	0	0	.1	.1	.1
Potential gross national product (percent difference)	0	0	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	7.8	17.7	26.6	31.5	32.9
Personal disposable income difference (billions of 1978 dollars)	10.9	18.4	25.4	30.0	32.0
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.1	5.4	4.9	4.7
Difference	−.1	−.4	−.5	−.6	−.5
Man-years of employment difference (thousands)	134.0	410.0	667.0	755.0	690.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.3	3.6	5.6	4.4	3.7
Rates of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.7	5.8	6.4	5.9
Nonfinancial corporate gross internal funds (percent difference)	.8	1.4	1.8	1.6	.6
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−50.8	−44.2	−14.0	5.2	8.3
Difference	−4.7	0	6.0	9.1	8.9

Source: Data Resources, Inc.

TABLE 3.—CAPITAL GAINS TAXED AS ORDINARY INCOME WITH THE TOP TAX RATE CUT TO 50 PERCENT AND PARTIAL INTEGRATION BY THE SHAREHOLDER CREDIT METHOD—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	6.1	10.9	13.7	11.4	8.2
Nonresidential fixed investment difference (billions of 1978 dollars)	.2	−1.6	−5.9	−10.7	−13.7
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	9.9	9.9	10.0	10.1
Difference	0	−.1	−.3	−.5	−.6
Potential gross national product (percent difference)	0	0	−.1	−.1	−.3
Personal consumption expenditures difference (billions of 1978 dollars)	5.4	11.7	19.3	23.1	23.9
Personal disposable income difference (billions of 1978 dollars)	8.7	16.8	24.2	25.7	25.5
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.2	5.7	5.1	4.9
Difference	−.1	−.2	−.3	−.3	−.3
Man-years of employment difference (thousands)	92.0	224.0	325.0	371.0	402.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.2	3.2	5.2	4.2	3.6
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.1	5.7
Nonfinancial corporate gross internal funds (percent difference)	−.8	−3.1	−5.2	−6.4	−7.3
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−0.6
New level	−48.6	−45.9	−21.1	−5.4	−2.9
Difference	−2.6	−1.6	−1.1	−1.5	−2.3

Source: Data Resources, Inc.

TABLE 4.—NO TAX ON CAPITAL GAINS—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollors)	9.4	28.9	47.7	55.8	57.4
Nonresidential fixed investment difference (billions of 1978 dollars)	1.4	8.0	17.9	25.4	28.3
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.7	11.3	11.5
Difference	0	.2	.5	.8	.8
Potential gross national product (percent difference)	0	.1	.3	.5	.7
Personal consumption expenditures difference (billions of 1978 dollars)	7.6	19.0	26.1	30.2	32.9
Personal disposable income difference (billions of 1978 dollars)	9.3	14.8	20.4	26.9	30.3
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.0	5.3	4.8	4.6
Difference	−.1	−.4	−.7	−.7	−.5
Man-years of employment difference (thousands)	132.0	485.0	829.0	906.0	784
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.4	3.9	5.9	4.6	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.7	5.9	6.6	6.0
Non-financial corporate gross internal funds (percent difference)	2.4	6.2	9.3	10.2	9.4
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−0.6
New level	−51.2	−42.6	−9.6	11.4	14.8
Difference	−5.1	1.7	10.3	15.2	15.4

Source: Data Resources, Inc.

TABLE 5.—CAPITAL GAINS AS ORDINARY INCOME AND FULL WRITEOFF OF CAPITAL LOSSES—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	−1.3	−5.7	−10.8	−14.1	−15.7
Nonresidential fixed investment difference (billions of 1978 dollars)	−.5	−3.5	−8.8	−13.5	−16.3
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	9.9	9.9	10.0	10.1
Difference	0	−.1	−.3	−.5	−.6
Potential gross national product (percent difference)	0	0	−.1	−.3	−.4
Personal consumption expenditures difference (billions of 1978 dollars)	−.8	−1.8	−1.1	−.5	−.8
Personal disposable income difference (billions of 1978 dollars)	−.5	.6	1.5	.8	.2
Unemployment rate (percent of labor force):					
New rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.5	6.1	5.5	5.2
Difference	0	.1	.1	.1	0
Man-years of employment difference (thousands)	−19	−87.0	−153.0	−147.0	−71.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	4.8	2.8	4.9	4.2	3.7
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6	5.6
New rate	5.9	5.5	5.4	5.8	5.4
Nonfinancial corporate gross internal funds (percent difference)	−1.3	−3.6	−5.6	−6.6	−7.1
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46	−44.3	−19.9	−3.9	−0.6
New level	−44.7	−44.0	−21.4	−6.6	−3.6
Difference	1.4	.2	−1.4	−2.7	−3.0

Source: Data Resources, Inc.

TABLE 6.—DIVIDEND DEDUCTIBILITY AT THE CORPORATE LEVEL—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	5.5	22.8	39.5	50.1	53.5
Nonresidential fixed investment difference (billions of 1978 dollars)	1.7	6.4	10.7	13.9	15.9
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.5	10.9	11.0
Difference	.1	.2	.3	.3	.4
Potential gross national product (percent difference)	0	.1	.1	.2	.4
Personal consumption expenditures difference (billions of 1978 dollars)	3.2	14.5	25.5	34.2	38.8
Personal disposable income difference (billions of 1978 dollars)	3.5	12.7	22.7	31.1	37.3
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.1	5.4	4.7	4.5
Difference	−.1	−.3	−.6	−.7	−.7
Man-year of employment difference (thousands)	66.0	371.0	699.0	911.0	922.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.2	3.8	5.8	4.7	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.7	5.8	6.4	6.1
Nonfinancial corporate gross internal funds (percent difference)	8.9	9.9	11.7	12.5	11.7
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−0.6
New level	−59.3	−52.6	−23.4	−5.5	−3.2
Difference	−13.3	−8.3	−3.4	−1.6	−2.6

Source: Data Resources, Inc.

TABLE 7.—DEFERRAL OF TAXATION FOR INVESTMENT ROLLOVER—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	4.7	14.4	23.7	28.9	31.5
Nonresidential fixed investment difference (billions of 1978 dollars)	.7	4.0	9.2	13.1	14.5
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.5	10.9	11.1
Difference	0	.1	.3	.4	.4
Potential gross national product (percent difference)	0	.1	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	3.8	9.5	13.1	15.6	18.0
Personal disposable income difference (billions of 1978 dollars)	4.6	7.4	10.0	13.8	16.8
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.2	5.6	5.1	4.9
Difference	−.1	−.2	−.3	−.3	−.3
Man-years of employment difference (thousands)	66.0	241.0	414.0	468.0	440.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.1	3.4	5.5	4.5	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.5	5.7	6.3	5.8
Nonfinancial corporate gross internal funds (percent difference)	1.2	3.1	4.6	5.2	4.7
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−0.6
New level	−48.6	−43.5	−14.9	4.0	7.7
Difference	−2.6	.8	5.0	7.9	8.3

Source: Data Resources, Inc.

TABLE 8.—SLIDING SCALE ADJUSTMENT FOR CAPITAL GAINS—ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	2.2	10.8	19.6	26.0	28.3
Nonresidential fixed investment difference (billions of 1978 dollars)	.4	3.4	8.3	12.1	13.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.5	10.9	11.1
Difference	0	.1	.3	.4	.4
Potential gross national product (percent difference)	0	.1	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	1.8	6.7	9.7	12.3	14.6
Personal disposable income difference (billions of 1978 dollars)	1.5	3.3	5.7	9.4	12.3
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.3	5.7	5.1	4.9
Difference	0	−.1	−.3	−.3	−.3
Man-years of employment difference (thousands)	29.0	165.0	321.0	394.0	374.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.0	3.4	5.5	4.5	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.3	5.7
Nonfinancial corporate gross internal funds (percent difference)	.8	2.6	4.0	4.9	4.4
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−46.8	−42.0	−13.5	6.1	9.9
Difference	0.8	2.3	6.4	10.0	10.4

Source: Data Resources, Inc.

TABLE 9.—CORPORATE TAX CUT TO 46 PERCENT ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	1.2	4.9	8.1	10.5	12.2
Nonresidential fixed investment difference (billions of 1978 dollars)	.4	1.6	2.6	3.4	3.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.3	10.6	10.7
Difference	0	0	.1	.1	.1
Potential gross national product percent difference	0	0	.1	.1	.1
Personal consumption expenditures difference (billions of 1978 dollars)	.6	2.8	4.5	6.0	7.5
Personal disposable income difference (billions of 1978 dollars)	.6	2.2	3.8	5.7	7.4
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.4	5.8	5.3	5.0
Difference	0	–.1	–.1	–.1	–.1
Man-years of employment difference (thousands)	14.0	79.0	141.0	171.0	192.0
Rates of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	4.9	3.1	5.2	4.4	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.5	6.0	5.6
Nonfinancial corporate gross internal funds percent difference	2.3	2.4	2.8	2.7	2.3
Federal Government budget position (billions of dollars, NIA basis):					
Base level	–46.0	–44.3	–19.9	–3.9	–.6
New level	–49.6	–46.4	–21.3	–4.7	–1.5
Difference	–3.5	–2.2	–1.4	–.8	–.9

Source: Data Resources, Inc.

TABLE 10.—CAPITAL GAINS TAXED AS ORDINARY INCOME—TOP TAX RATE CUT TO 50 PERCENT NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	–3.4	–13.8	–22.2	–20.1	–14.4
Nonresidential fixed investment difference (billions of 1978 dollars)	–.8	–6.2	–14.8	–20.5	–21.4
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	9.8	9.7	9.8	9.9
Difference	0	–0.2	–.5	–.8	–.8
Potential gross national product percent difference	0	–.1	–.2	–.4	–.5
Personal consumption expenditures difference (billions of 1978 dollars)	–2.3	–6.4	–7.2	–5.6	–4.3
Personal disposable income difference (billions of 1978 dollars)	–2.1	–2.4	–3.5	–4.5	–3.5
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.6	6.2	5.6	5.1
Difference	0	.2	.3	.2	0.
Man-years of employment difference (thousands)	–48.0	–217.0	–364.0	–245.0	25.0
Rates of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	4.7	2.5	4.7	4.4	4.1
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.5	5.3	5.8	5.4
Nonfinancial corporate gross internal funds percent difference	–2.1	–5.7	–8.3	–8.0	–7.5
Federal Government budget position (billions of dollars, NIA basis):					
Base level	–46.0	–44.3	–19.9	–3.9	–.
New level	–43.7	–45.0	–22.2	–3.2	5.6
Difference	2.3	–.7	–2.3	.6	5.2

Source: Data Resources, Inc.

TABLE 11.—PARTIAL INTEGRATION BY THE SHAREHOLDER CREDIT METHOD NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	9.0	20.0	25.4	21.8	17.7
Nonresidential fixed investment difference (billions of 1978 dollars)	1.0	3.8	6.7	8.1	3.1
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	10.1	10.4	10.7	10.7
Difference	0	.1	.2	.2	0
Potential gross national product percent difference	0	0	.1	.1	.2
Personal consumption expenditures difference (billions of 1978 dollars)	7.7	16.3	22.1	24.5	25.5
Personal disposable income difference (billions of 1978 dollars)	11.0	18.2	24.1	26.6	26.7
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.1	5.5	5.1	5.0
Difference	−.1	−0.3	−.4	−.3	−.2
Man-years of employment difference (thousands)	132.0	374.0	504.0	416.0	264.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.3	3.5	5.3	4.1	3.6
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.7	5.7	6.2	5.7
Nonfinancial corporate gross internal funds percent difference	.8	1.0	.3	−.9	−2.0
Federal Government budget position (billions of, dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−50.9	−46.2	−20.8	−7.5	−7.7
Difference	−4.9	−1.9	−.9	−3.6	−7.1

Source: Date Resources, Inc.

TABLE 12.—CAPITAL GAINS TAXED AS ORDINARY INCOME WITH THE TOP TAX RATE CUT TO 50 PERCENT AND PARTIAL INTEGRATION BY THE SHAREHOLDER CREDIT METHOD NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	5.6	7.7	7.8	6.9	8.2
Nonresidential fixed investment difference (billions of 1978 dollars)	.2	−2.1	−7.3	−12.6	−14.8
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	9.9	9.9	10.0	10.0
Difference	0	−.1	−.3	−.5	−.6
Potential gross national product percent difference	0	0	−.1	−.2	−.3
Personal consumption expenditures difference (billions of 1978 dollars)	5.4	10.8	17.4	21.2	23.4
Personal disposable income difference (billions of 1978 dollars)	8.8	16.4	22.5	23.5	24.4
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.3	5.8	5.2	4.9
Difference	−.1	−.1	−.2	−.2	−.3
Man-years of employment difference (thousands)	87.0	173.0	215.0	272.0	399.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.2	3.1	5.1	4.2	3.8
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.5	6.1	6.7
Nonfinancial corporate gross internal funds percent difference	−.9	−3.7	−6.1	−7.0	−7.1
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−49.1	−47.9	−24.3	−7.8	−2.7
Difference	−3.0	−3.7	−4.4	−3.9	−2.1

Source: Data Resources, Inc.

TABLE 13.—NO TAX ON CAPITAL GAINS—NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	9.5	27.6	36.7	30.6	23.1
Nonresidential fixed investment difference (billions of 1978 dollars)	1.4	7.9	16.3	20.1	18.8
Fixed nonresidential investment as a percent of GNP:					
New Ratio	9.8	10.2	10.7	11.2	11.3
Difference	0	.2	.5	.7	.6
Potential gross national product percent difference	0	.1	.2	.4	.5
Personal consumption expenditures difference (billions of 1978 dollars)	7.7	18.9	23.5	22.8	22.5
Personal disposable income difference (billions of 1978 dollars)	9.3	15.0	19.9	22.3	22.3
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.0	5.4	5.1	5.1
Difference	−.1	−.4	−.5	−.3	−.1
Man-years of employment difference (thousands)	133.0	473.0	669.0	473.0	162.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.4	3.8	5.5	4.0	3.4
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5,9	5.7	5.8	6.3	5.6
Nonfinancial corporate gross internal funds (percent difference)	2.4	5.9	7.3	6.1	4.5
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−51.1	−43.9	−18.0	−7.0	−12.2
Difference	−5.1	.4	2.0	−3.1	−11.7

Source: Data Resources, Inc.

TABLE 14.—CAPITAL GAINS AS ORDINARY INCOME AND FULL WRITE-OFF OF CAPITAL LOSSES—NON-ACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	−1.5	−6.6	−10.8	−9.4	−6.0
Nonresidential fixed investment difference (billions of 1978 dollars)	−.5	−3.6	−8.9	−12.7	−13.8
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.7	9.9	9.9	10.0	10.1
Difference	0	−.1	−0.3	−.5	−.5
Potential gross national product percent difference	0	0	−.1	−.3	−.3
Personal consumption expenditures difference (billions of 1978 dollars)	−.8	−2.1	−1.4	.4	1.8
Personal disposable income difference (billions of 1978 dollars)	−.5	.3	.6	.7	1.7
Unemployment rate (percent of Labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.5	6.1	5.5	5.1
Difference	0	.1	.1	0	−.1
Man-years of employment difference (thousands)	−20.0	−102.0	−165.0	−80.0	100.0
Rate od change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	4.8	2.7	4.9	4.4	3.9
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.5	5.4	5.9	5.5
Nonfinancial corporate gross internal funds percent difference	−1.4	−3.8	−5.5	−5.7	−5.7
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−44.8	−44.4	−20.5	−2.5	4.0
Difference	1.3	−.1	−.6	1.3	4.6

Source: Data Resources, Inc.

TABLE 15.—DIVIDEND DEDUCTIBILITY AT THE CORPORATE LEVEL—NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	7.1	30.0	46.4	47.5	36.9
Nonresidential fixed investment difference (billions of 1978 dollars)	1.9	7.7	12.9	15.1	13.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.2	10.5	10.9	11.0
Difference	.1	.2	.3	.4	.4
Potential gross national product percent difference	0	.1	.1	.3	.4
Personal consumption expenditures difference (billions of 1978 dollars)	3.5	16.7	28.2	34.3	34.4
Personal disposable income difference (billions of 1978 dollars)	3.2	14.1	26.1	33.1	35.5
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.3	6.0	5.3	4.8	4.7
Difference	—.1	—.4	—.7	—.7	—.4
Man-years of employment difference (thousands)	85.0	495.0	857.0	906.0	638.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.2	4.0	5.8	4.3	3.3
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	6.0	5.8	5.8	6.4	5.9
Nonfinancial corporate gross internal funds percent difference	9.3	11.3	12.8	11.5	8.4
Federal Government budget position (billions of dollars, NIA basis):					
Base level	—46.0	—44.3	—19.9	—3.9	—.6
New level	—58.0	—48.9	—20.7	—7.8	—14.6
Difference	—11.9	—4.6	—.7	—4.0	—14.0

Source: Data Resources, Inc.

TABLE 16.—DEFERRAL OF TAXATION FOR INVESTMENT ROLLOVER—NONACCOMMODATING MONETARY POLICY

	1978	1979	1981	1981	1982
Gross national product difference (billions of 1978 dollars)	4.7	14.0	19.1	16.7	13.8
Nonresidential fixed investment difference (billions of 1978 dollars)	.7	4.0	8.5	10.5	9.6
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.5	10.9	11.0
Difference	0	.1	.3	.4	.3
Potential gross national product percent difference	0	.1	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	3.8	9.5	12.1	12.2	12.7
Personal disposable income difference (billions of 1978 dollars)	4.6	7.6	10.2	11.9	12.5
Unemployment rate (percent of labor force):					5.2
Base rate	6.4	6.4	5.9	5.4	5.1
New rate	6.3	6.2	5.7	5.2	
Difference	—.1	—.2	—.3	—.2	—.1
Man-years of employment difference (thousands)	67.0	239.0	348.0	260.0	118.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.1	3.4	5.3	4.2	3.6
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.2	5.6
Nonfinancial corporate gross internal funds percent difference	1.2	3.0	3.7	3.2	2.3
Federal Government budget position (billions of dollars, NIA basis):					
Base level	—46.0	—44.3	—19.9	—3.9	—.6
New level	—48.6	—44.0	—18.7	—4.9	—5.6
Difference	—2.5	.3	1.2	—1.1	—5.1

Source: Data Resources, Inc.

TABLE 17.—SLIDING SCALE ADJUSTMENT FOR CAPITAL GAINS—NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	2.4	10.7	15.2	12.9	10.4
Nonresidential fixed investment difference (billions of 1978 dollars)	.5	3.5	7.7	9.6	8.8
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.5	10.8	11.0
Difference	0	.1	.3	.3	.3
Potential gross national product percent difference	0	.1	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	1.8	6.8	8.7	8.6	9.0
Personal disposable income difference (billions of 1978 dollars)	1.4	3.5	5.6	7.1	7.6
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.3	5.7	5.3	5.2
Difference	0	−.1	−.2	−.1	0
Man-years of employment difference (thousands)	30.0	168.0	261.0	172.0	37.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.0	3.4	5.3	4.2	3.7
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.6	6.1	5.5
Nonfinancial corporate gross internal funds percent difference	.8	2.5	3.2	2.8	2.0
Federal Government budget psoition (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−46.7	−42.2	−17.0	−2.9	−3.3
Difference	−.6	2.0	2.9	.9	−2.7

Source: Data Resources, Inc.

TABLE 18.—CORPORATE TAX CUT TO 46 PERCENT—NONACCOMMODATING MONETARY POLICY

	1978	1979	1980	1981	1982
Gross national product difference (billions of 1978 dollars)	1.7	7.3	10.4	10.6	9.6
Nonresidential fixed investment difference (billions of 1978 dollars)	.5	2.1	3.3	3.9	3.3
Fixed nonresidential investment as a percent of GNP:					
New ratio	9.8	10.1	10.3	10.6	10.7
Difference	0	.1	.1	.1	.1
Potential gross national product percent difference	0	.1	.1	.2	.3
Personal consumption expenditures difference (billions of 1978 dollars)	.7	3.6	5.5	6.5	7.2
Personal disposable income difference (billions of 1978 dollars)	.6	2.9	5.3	7.1	8.2
Unemployment rate (percent of labor force):					
Base rate	6.4	6.4	5.9	5.4	5.2
New rate	6.4	6.3	5.8	5.3	5.2
Difference	0	−.1	−.1	−.1	0
Man-years of employment difference (thousands)	21.0	112.0	150.0	102.0	26.0
Rate of change in real GNP (percent):					
Base rate	4.9	3.0	5.1	4.3	3.8
New rate	5.0	3.2	5.2	4.3	3.7
Rate of change in implicit price deflator (percent):					
Base rate	5.9	5.5	5.5	6.0	5.6
New rate	5.9	5.6	5.5	6.1	5.5
Nonfinancial corporate gross internal funds percent difference	2.4	2.8	2.9	2.5	1.7
Federal Government budget position (billions of dollars, NIA basis):					
Base level	−46.0	−44.3	−19.9	−3.9	−.6
New level	−49.1	−45.2	−20.4	−5.1	−3.9
Difference	−3.1	−.9	−.4	−1.2	−3.3

Source: Data Resources, Inc.

TABLE 19.—DATA RESOURCES, INCORPORATED BASELINE FORECAST (AUGUST 1977)

	1978	1979	1980	1981	1982
Gross national products (billions of 1978 dollars)	2,100.1	2,162.2	2,272.7	2,340.4	2,460.1
Nonresidential fixed investment (billions of 1978 dollars)	210.6	222.5	238.5	256.3	269.6
Fixed nonresidential investment as a percent of GNP	10.0	10.3	10.5	10.8	11.0
Potential gross national products (billions of 1978 dollars)	2,181.5	2,254.6	2,330.2	2,406.0	2,481.5
Personal consumption expenditures (billions of 1978 dollars)	1,333.2	1,375.3	1,434.8	1,492.4	1,547.9
Personal disposable income (billions of 1978 dollars)	1,452.0	1,489.0	1,549.7	1,606.9	1,666.1
Unemployment rate (percent of labor force)	6.4	6.4	5.9	5.4	5.2
Man-years of employment (millions)	93.0	94.9	97.2	99.4	101.2
Rate of change in real GNP (percent)	4.9	3.0	5.1	4.3	3.8
Rate of change in implicit price deflator (percent)	5.9	5.5	5.5	6.0	5.6
Nonfinancial corporate gross internal funds (billions of 1978 dollars)	145.6	151.4	157.2	166.6	180.0
Federal Government budget position (billions of dollars, NIA basis)	−46.0	−44.3	−19.9	−3.9	−6.6
Debt-equity ratio	1.346	1.375	1.403	1.439	1.455
Nonresidential fixed capital stock (billions of 1978 dollars)	1,647.3	1,706.4	1,774.3	1,851.6	1,932.9

Source: Data Resources, Inc.

APPENDIX B.—HISTORY OF TAXATION OF INVESTMENT INCOME

TAXATION OF CAPITAL GAINS

1913–1921

From the beginning of the income tax in 1913 through 1921, there was no statutory provision for taxing capital gains. Gains realized by both individuals and corporations were taxed as ordinary income. Capital losses were not deductible through 1915. Losses could be deducted to offset gains in 1916 and 1917; and they were fully deductible against both gains and ordinary income from 1918 to 1921.

1922–1933

The Revenue Act of 1921 defined capital assets, and provided special treatment for gains realized by individuals. The taxation of capital gains received by corporations remained the same. The '21 Act defined capital assets as property held for more than two years, but excluded stock in trade or property included in inventory. From 1922 through 1933, individuals realizing capital gains could elect to use an alternative rate of 12.5 percent. The top marginal bracket on ordinary income fluctuated from 25 percent to 63 percent during this period. Long-term capital losses were deductible, but the offset against ordinary income was limited to 12.5 percent of long-term losses from 1924 through 1933. Short-term capital losses were fully deductible against ordinary income.

1934–1941

The Revenue Act of 1934 redefined capital assets to cover assets regardless of the length of time held, except property held primarily for sale to customers. The 12.5 percent alternative rate for individuals was repealed, and a five-step sliding scale was substituted. The percentage of gains and losses included in the tax base depended on the time the assets had been held. Gains or losses on assets held less than one year were fully included in the tax base. For assets held over ten years, only 30 percent of gains and losses were included in the tax base. Regular income tax rates were applied to that portion of gains included in the tax base, with up to $2,000 of net capital losses deductible from ordinary income.

The Revenue Act of 1938 substituted a three-step scale for including percentages of gains and losses in the tax base. Gains or losses from assets held less than eighteen months were designated short-term gains, and those held longer were considered long-term gains. All short-term gains and losses were included in the tax base. One third of long-term gains was excluded from the base if the assets were held less than two years. Half of the gain was excluded if the asset were held more than two years. A ceiling rate of 30 percent was applied against gains included in the tax base. Thus, the effective rate was 20 percent on assets held 18–24 months; and 15 percent on assets held more than two years.

The allowance for capital losses against ordinary income for individuals corresponded to the sliding scale for inclusion of gains in the tax base. Thirty percent of losses could be taken as a credit against tax on other income.

In 1940 and 1941, corporations could deduct long-term losses against ordinary income, but neither individuals nor corporations could offset short-term losses against ordinary income. Such losses could be carried forward to the following year to offset short-term gains.

1942–1950

The present tax treatment of capital gains and losses dates largely from the Revenue Act of 1942. Instead of the sliding scales, capital assets were reduced to two classes—short term and long term—distinguished by an asset holding period of six months. Half of the long-term gains of individuals was included in the tax base. All long-term gains of corporations, as well as all short-term gains of both individuals and corporations, were included in the tax base. An alternative rate of 25 percent was applied to total long-term gains for individuals and for corporations.

The treatment of capital losses was also changed. Individuals were allowed a $1,000 offset of net capital losses against ordinary income, and a five-year carry forward of losses to be applied against gains and $1,000 of ordinary income.

1951–1968

The temporary income tax increase enacted in the Revenue Act of 1951 included an increase to 26 percent in the alternative rate on capital gains for both individuals and corporations. The full offset of short-term losses against long-term gains enacted in 1942 was repealed.

When the temporary tax increase for individuals enacted in 1951 expired at the end of 1953, the alternative tax rate on capital gains reverted to 25 percent for corporations as well as individuals.

The Revenue Act of 1964 allowed individuals full carry-over of losses until exhausted, but continued the annual limit of $1,000 applied against ordinary income.

1969–1975

The Tax Reform Act of 1969 restricted the use of the alternative rate to $50,000 of capital gains, with gains exceeding $50,000 subject to regular rates. Since one-half of the gain is deducted and the maximum regular marginal rate is seventy percent, the effective maximum capital gains rate was increased to 35 percent. The '69 Act also imposed a minimum tax on items designated "tax preferences" and Congress declared that the "untaxed" half of net gains was a tax preference item. Exemption from the minimum tax was provided for the first $30,000 of preference items. In addition, total preference items could be reduced by deducting an amount equal to ordinary taxes paid. Following these calculations, a 10 percent minimum tax was imposed on tax preference items in addition to other taxes.

The effect of this provision was to increase the maximum tax on capital gains 5 percent (10 percent rate applied to one-half of the gain produces an effective rate of 5 percent on the gain). When the minimum tax is added to the increases in capital gains taxes, the combined effect was to increase the maximum capital gains tax rate from 25 percent to 40 percent. In short, the '69 Act increased capital gains taxes 60 percent.

For corporations, the '69 Act provided that three-eighths of capital gains was a tax preference item, compared to one-half of the gain for individual taxpayers.

With respect to capital loss restrictions, the '69 Act provided that only one-half of long-term capital losses could be used to offset ordinary income. Under this provision, $2,000 in losses were required to offset $1,000 of ordinary income. The '69 Act thus cut the capital loss offset in half.

Prior to 1969, capital gains could not be included with averaging income. In fact, averageable income was reduced by the amount of gains. The '69 Act provided for inclusion of gains in averageable income and liberalized averaging rules. However, taxpayers who chose to income average were precluded from using the alternative tax calculation.

The '69 Act provided a three-year loss carryback for corporations. However, the carryback could not be used to create or increase a net operating loss. Prior to 1969, carryback for capital losses to previous years was not allowed.

1976—Present

The Tax Reform Act of 1976 extended the holding period for capital gains to one year, effective in 1978. The change was phased-in by setting the holding period for 1977 at nine months.

The '76 Act also increased the minimum tax rate to 15 percent for individuals and corporations. In addition, the exclusion of the amount of preference income subject to the minimum tax was reduced for individuals to the greater of $10,000 or one-half of regular taxes. For corporations, the exemption was reduced to the greater of $10,000 or the company's regular taxes. The Act also repealed a provision which has allowed corporations to carry forward regular taxes not used to offset preference income in the current year.

The Tax Reform Act of 1969 had established a maximum tax of 50 percent on "earned" income (i.e. salaries and wages, rents and royalties). However, for each dollar of preference income above the $30,000 exemption, a dollar of earned income would be subject to regular rates (up to 70 percent) instead of the maximum tax. The '76 Act eliminated the $30,000 exemption. Thus, for each two dollars of capital gains, one dollar of earned income is subject to ordinary tax rates, since one-half of capital gains are considered to be "preference" income.

Finally, the offset of ordinary income by capital losses had been limited to $1,000 since 1942. The '76 Act increased the offset to $2,000 in 1977 and $3,000 in 1978 and subsequent years. The '76 Act did not alter provisions of the code which require $2 of long-term losses to offset $1 of income. Thus, as of 1978, up to $6,000 of capital losses can be used to offset up to $3,000 of ordinary income.

In 1977, the highest taxes on capital gains reached 49.125 percent, due to the combined effect of capital gains taxes, the minimum tax and the maximum tax. For corporations, capital gains could be subject to taxes of up to 37.5 percent. At the same time, the period an investment must remain at risk was doubled when the holding period was extended from six months to one year.

DOUBLE TAXATION OF DIVIDENDS

1913–1935

Corporate income distributed as dividends has been subject to taxation at both the corporate and shareholder levels since the inception of the individual income tax in 1913. Although dividends received by individuals were not subject to "normal" or regular tax during this period, they were subject to a surtax. The corporate income tax rate, initially one percent in 1909, climbed to 12 percent in 1918. The corporate rate was reduced to 10 percent in the following year and fluctuated between 10 and 13.75 percent through 1935. An additional excess profits tax was imposed on corporations during World War I.

1936–1937

In 1963, dividends were subject to "normal" individual income tax for the first time. The corporate income tax was graduated with rates ranging from 8 to 15 percent. In an attempt to encourage dividend payouts in the midst of a depression, the Congress also adopted a corporate surtax on undistributed earnings. This additional tax on corporate retained earnings ranged from 7 to 27 percent. The surtax produced a marked increase in dividend payouts at the expense of retained earnings.

1938–1953

Dividends remained subject to full taxation for individuals. The surtax for undistributed corporate profits was abolished. A graduated corporate tax rate was maintained. The rate on the first $25,000 of earnings was maintained. The rate on the first $25,000 of earnings fluctuated during the period from 12.5 to 30 percent; the maximum corporate tax rate varied from 19 to 53 percent. Additional excess profits taxes were again imposed on corporations during World War II and the Korean conflict.

In 1944–45, the impact of double dividend taxation was the most pronounced. In these years, the maximum corporate tax rate reached 53 percent, and the maximum individual rate was 94 percent. At these rates, one dollar of corporate income distributed as dividends could be reduced to less than three cents in after-tax income to the shareholder.

1954–1964

In 1954, Congress enacted two measures to mitigate the effect of double dividend taxation—a $50 per person dividend exclusion and a dividend tax credit. The tax credit was established at 4 percent of dividend income after the original proposal of a 10 percent credit was reduced in conference. Corporate tax rates during the period were 30 percent on the first $25,000 of income and 52 percent over $25,000.

1964 to Present

The dividend tax credit was reduced to 2 percent in 1964 and eliminated the following year. At the same time, the dividend exclusion was increased from $50 to $100. Corporate tax rates generally declined during the period, except for the surcharge imposed during 1968–1969. Current corporate tax rates are 20 percent on the first $25,000 of earnings, 22 percent between $25,000 and $50,000, and 48 percent over $50,000.

The maximum impact of double dividend taxation under current law is to reduce one dollar of distributed corporate income to 15½ cents in after-tax earnings to the shareholder. This results from imposition of the maximum corporate rate (48 percent) and the maximum individual rate (70 percent).

Appendix C.—Glossary

This glossary contains explanations of terms used in Chapter IV, with which the average reader may not be completely familiar.

Cash flow.—The sum of undistributed profits, foreign branch profits and capital consumption allowances, net of inventory valuation adjustment.

Debt-equity ratio.—The ratio between debt and equity, where debt equals the sum of bank loans, mortgages, bonds, open market paper, finance company loans, and miscellaneous liabilities. Equity equals total assets less total liabilities.

Econometric model.—An econometric model (in this case, of the entire U.S. economy) is a collection of relationships between economic variables, with parameters based upon statistical analysis of existing data. Thus, for example, economic theory may predict that consumption is related to income and other variables such as consumer confidence and wealth. When the most important economic relationships are specified and aggregated, the model can be used to analyze the likely effects on the economy of policy changes and to project future developments.

Wealth effect.—The impact on consumer spending resulting from a change in the value of individual asset holdings. For example, an increase in stock prices should lead to additional consumer spending as individuals become wealthier and feel able to spend more and save less at a given level of income.

Senator Byrd. The next witnesses will be a panel consisting of Richard M. Siemsen, corporate tax director, Emerson Electric Co.; Paul H. Ozan, American Greetings Co.; James Stone, manager, planning and venture analysis, Southwire Co.; and Thomas E. Bundy, treasurer, American Industrial Development Council.

I think that we have more people than that involved. I think that you had better proceed to identify yourselves, before you begin.

STATEMENT OF RICHARD H. SIEMSEN, CORPORATE TAX DIRECTOR, EMERSON ELECTRIC CO.; ACCOMPANIED BY RAMSAY D. POTTS, COUNSEL; PAUL H. OZAN, ASSISTANT GENERAL COUNSEL, AMERICAN GREETINGS CO.; JAMES STONE, MANAGER, PLANNING AND VENTURE ANALYSIS, SOUTHWIRE CO.; THOMAS E. BUNDY, TREASURER, AMERICAN INDUSTRIAL DEVELOPMENT COUNCIL; AND HERSCHEL H. FRIDAY, THE MARMON GROUP INC.

Mr. Siemsen. Mr. Chairman, there are several supporting personnel to the witnesses.

Senator Byrd. Fine.

I might explain to the panel that we have a series of votes so we will be coming and going, but it will probably not make any great difference. The chairman will be coming back after the vote.

I might say that this is a very difficult way to legislate. I have just left the Armed Services Committee, where there is a vitally important matter, because the Finance Committee was meeting simultaneously. Now there is a vote on a piece of legislation which will authorize appropriation for elementary and secondary education twice as much money as was appropriated for the current fiscal year.

You gentlemen may proceed.

Mr. SIEMSEN. Thank you, Mr. Chairman, and members of the committee. My name is Richard Siemsen. I am corporate tax director of Emerson Electric Co. With me this morning is our outside counsel, Mr. Ramsay D. Potts of Shaw, Pittman, Potts & Trowbridge, here in Washington.

We will limit our testimony so that Mr. Herschel Friday, representing the Marmon Group Inc., may make a brief statement.

Emerson is a publicly held company, principally engaged in the manufacture and sale of a broad range of electrical and electronic products and systems for commercial, industrial, military, and consumer use.

I am appearing here today to urge this committee to increase the tax exempt limits on small issue industrial development bonds, which I will refer to hereafter as small issue IDB's. Emerson seeks an increase of the present $1 million exempt limit, which is not subject to the so-called capital expenditures limitation to $3 million; and an increase from $5 million to $15 million of the exemption subject to the capital expenditures limitation.

During the past 30 years, Emerson Electric has been using small issue IDB's to construct new plants, expand existing facilities and purchase new equipment. Since 1948, we have financed 24 new plants, and 11 plant expansions in 18 States across the country.

The availability of small issue IDB financing has led Emerson to undertake more substantial investment than the average dollar amount of the small issue IDB would indicate. Although the average dollar value of each of the small issue IDB's used by Emerson over the years has been $2.4 million, today Emerson's average total investment in each of these IDB-financed facilities approximates $6.2 million. In short, in Emerson's experience the tax exemption for small issue IDB interest has provided an effective incentive for industrial and economic expansion by reducing the interest cost of borrowed "seed money."

The tax exemption for small issue IDB's has also benefited the municipalities which issue such bonds. The construction and expansion of IDB financed industrial facilities—provide new jobs, thus stimulating local economies. For example, Emerson's IDB-financed facilities when first built or expanded employed 6,200 workers. Those facilities now employ 14,500 individuals. These positions are actual net additions to the labor force. Emerson's IDB-financed facilities have been located in both large and small communities, ranging in size from approximately 2,500 to almost 200,000.

In many of these communities, Emerson has found that due to the consistent decline in agricultural labor force over the last 70 years, that, many workers are available. In my role as corporate tax director, I have spoken to many Industrial Development Commission members who have stated unequivocally that, due to the steady decline in the agricultural employment, industrial expansion in their respective communities is essential to the communities' economic survival.

In addition to the direct benefits afforded by small issue IDB's, the use of IDB's has collaterally benefited their municipal issuers by involving them in the process of industrial development in their respective communities. In this way IDB financing has resulted in a more effective and environmentally compatible development of industrial areas in the issuing municipalities.

Unfortunately, Emerson and other IDB users have encountered difficulties in using small issue IDB's due to the combined impact of inflation and the overly restrictive capital expenditures limitation. Since Congress established the limit in 1968, the costs of commercial and industrial facilities have more than doubled. Machinery and equipment costs have kept pace, and continue to rise at an alarming rate. Therefore, enacting our proposed increases in the tax exemptions would merely reinstate the incentive value of the bonds to the level contemplated by Congress in 1968 and maintain that level against the effects of inflation for at least the next few years.

Our proposal will benefit the national economy by restoring an effective incentive for investment and capital formation to meet the Nation's immediate need for increased production capacity.

Senator BYRD. I am sorry. We will have to take a brief recess. I must leave now, or I will miss the vote. Before I leave, I want to say a special word of welcome to my friend, Ramsay Potts.

Mr. POTTS. Thank you, Senator.

Senator BYRD. If you will standby, Senator Long will be here in just a moment.

[Brief pause.]

The CHAIRMAN. Gentlemen, we will be very happy to hear your statements.

You have 1 minute remaining, Mr. Siemsen.

Mr. SIEMSEN. Thank you, Mr. Chairman.

As I stated earlier, the increase in the tax exempt limitations for small issue IDB's which we propose, will benefit the national economy by restoring an effective incentive for investment and by providing a method of capital formation sufficient to meet the increasing need to expand productive capacity.

According to a study prepared by the Congressional Budget Office in August 1976 the growth rate in the amount of private plant and equipment in the United States has declined from 4.3 percent per year in the period from 1965 to 1970, to 3.3 percent per year for the period 1970 to 1975. The rate was expected to decline to 2.5 percent per year in the period 1975 to 1977.

During a recent hearing before the House Ways and Means Committee, held on the administration's tax proposals, well-documented testimony was presented to the effect that small issue IDB's can effectively stimulate investment and job creation. Congress should seize this opportunity to restore this proven method of providing such critical investment stimulus.

It is important to note that our proposal is compatible with the administration's efforts to reduce unemployment in the urban areas. The decline in the agricultural labor force from 4.9 million in 1967 to 4.1 million in 1977 has resulted in a migration of agricultural workers to our urban areas. This migration has contributed to the problems in our large cities in several ways. For example, if the migrating worker finds permanent employment in a city, that worker has reduced the availability of employment for a city resident. If the city resident is consequently unable to find work in the urban area, that resident will likely join the swelling number of individuals on the city's unemployment and welfare rolls. Conversely, if the migrating worker cannot find permanent employment in the city, that worker will likely file for unemployment compensation and welfare benefits in the urban area.

Our proposal would reduce the migration of the former agricultural worker by providing employment opportunity for that worker in the local communities. The creation of such new jobs will benefit not only the local communities but also our major metropolitan areas by acting to alleviate the alarming trend in urban unemployment levels.

Finally, we would comment that the additional Federal and State revenues in the form of income and FICA taxes on wages of workers employed at the IDB-financed facilities would serve to offset the amount of foregone Federal income tax on the IDB interest and in many cases could yield a net tax benefit to the Treasury.

Thank you for your time and attention.

The CHAIRMAN. Next we will hear from Mr. Paul Ozan, American Greetings.

STATEMENT OF PAUL OZAN, ASSISTANT GENERAL COUNSEL, AMERICAN GREETINGS CORP.

Mr. OZAN. My name is Paul Ozan, assistant general counsel and assistant secretary of American Greetings Corp.

American Greetings Corp. is a publicly held corporation principally engaged in the manufacture and sale of greeting cards, gift wrapping, and display fixtures. I am appearing today for American Greetings to urge this committee to increase the tax-exempt limits on the issue amounts of small-issue industrial development bonds from $5 million to $15 million, subject to the so-called capital expenditures limitation.

American Greetings also seeks an increase of the present $1 million exempt limit, which is not subject to the capital expenditures limitation, to $3 million.

During the past 17 years, American Greetings has used the proceeds of numerous issues of tax-exempt small-issue industrial development bonds to build new plants, expand existing plants, and to acquire additional machinery and equipment. American Greetings first used the proceeds of an IDB issue to finance a new plant in Osceola, Ark., in 1960. Since that time, American Greetings has financed 11 more new plants with small-issue IDB proceeds.

In all instances, the plantsite location selected was determined by a very careful analysis of the labor supply available. These were areas wherein the basic employment opportunities were agriculture or agriculturally oriented. The locations had seen a steady exodus of their young people to the larger cities due to the lack of job opportunities. In all instances, this trend was reversed with the introduction of a new industrial facility.

The U.S. Department of Commerce has estimated that the creation of 100 industrial jobs creates 65 additional service jobs. Thus, the impact of an industrial facility employment of 300 to 400 people can be quite dramatic to a small community and the labor force area surrounding it.

The availability of industrial development bonds is of prime importance to companies in the creation of new jobs. A publication entitled "Statistical Abstract of Long-Term Municipal Bond Dollar Volume—January 1970 to September 1976," prepared for the American Industrial Development Council by James G. Belch, indicates that the net public indirect cost of each job created by an industrial development bond in 1975 was only $3,727.

In the case of American Greetings, total domestic employment in 1960 was 2,622. At the end of 1977, domestic employment was 12,780, or an increase of 10,158 jobs. All space expansion was financed through $41,800,000 of industrial development bonds.

If we assume that the average taxable interest that would have been paid was 7.5 percent and the bonds were issued in an even progression so as to have an average amount outstanding of $20,900,000 for the 17 years and with a tax rate of 50 percent, the net public indirect cost of each of the 10,158 jobs created was $1,311.65. Compare this with the previously proposed direct federally subsidized job programs costing $5 billion to create 130,000 jobs, or $38,461.54 per job.

In recent years, American Greetings has noted a marked decline in the usefulness of small-issue IDB's due to the combined effects of inflation and the capital expenditures limitation. We have also noted the development of a groundswell of support in the corporate community in favor of legislative action to increase the exempt IDB limits to a usable level; American Greetings wholeheartedly concurs in this view.

American Greetings therefore urges the Congress to increase the clean $1 million limit to $3 million, and to increase the $5 million limit subject to the capital expenditures rule to $15 million.

Any lesser increase, such as the increase from $5 million to $10 million that would be provided by section 321 of H.R. 13511, of course, would improve matters, but it could not adjust for the post-1968 inflation and keep pace with rising costs of commercial and industrial construction in the immediate future.

Thank you, Mr. Chairman.

The CHAIRMAN. Next, we will hear from Mr. James Stone, manager of planning and venture analysis of Southwire.

STATEMENT OF JAMES STONE, MANAGER OF PLANNING AND VENTURE ANALYSIS, SOUTHWIRE CO.

Mr. STONE. My name is James Stone. I am the manager of planning and venture analysis of Southwire Co., which is headquartered in Carrollton, Ga.

I wish to discuss briefly Southwire's experience with small-issue industrial development bonds, which are governed under section 103(b) of the Internal Revenue Code.

Southwire was organized in 1950, and had sales of $500,000. This, today, has grown to $500 million in annual sales. We believe that this record of growth is attributable to hard work, ingenuity, advanced technology, and superior service to our customers.

One of the most valuable financial tools Southwire has been able to use in our expansion program is the industrial development bond. Establishment or expansion of our facilities in Georgia, Illinois, Arkansas, Kentucky, and Connecticut would have been impossible without industrial development bond financing.

That is a point that I want to emphasize. During recent years, there have been many times when money for investment and capital expansion was unavailable to Southwire, and other companies similarly situated. Consequently, on many occasions, Southwire has been forcd to forgo opportunities for expansion, expansion that would have created new jobs.

The primary reason we have had to pass up those opportunities is that the "small issue" industrial development bond is no longer helpful to us because of the impact of certain restrictions placed on its use in 1968. The effect of those restrictions has been magnified by the high rate of inflation experienced in this country recently.

The $5 million limit on the size of small issue industrial development bonds in conjunction with the capital expenditure limitation set forth in section 103(b) of the code has been very harmful to us in our efforts to expand. We have a number of new projects on which we cannot begin work until adequate industrial development bond financing is available. None of those projects can fit within the existing limitations.

Of course, there is also a provision in 103(b) of the code that provides for up to $1 million in small-issue IDB's that are not subject to the capital expenditures limitation. This amount is so small that it provides no effective incentive to capital formation and economic expansion.

It is widely recognized that during the recent past, capital investment in this country has not been increasing at the necessary rate in order to keep our labor force employed and to alleviate our balance-of-payments problems. To increase productivity, we must have capital formation. To have capital formation, we must have the financing which is made possible through industrial development bonds.

Therefore, Southwire believes it necessary and beneficial to the country to restore the incentive value of small issue IDB. Inflation since 1968 and projections for continued inflation dictate that the limits on the size of the small issue IDB's subject to the capital expenditure restriction and those not subject to the restriction must be raised by well over 100 percent to restore and preserve, for at least a few years, the incentive to expansion of productive capacity and increased capital formation provided by small issue IDB's at the level intended by Congress when the limitations were imposed in 1968.

In conclusion, it is Southwire's recommendation that the limit on the small issue IDB's subject to the capital expenditures limitations be increased from $5 million to $15 million, and that the maximum limit on those bonds that are not subject to the capital expenditures limitation be increased from $1 million to $3 million.

I hope in considering the various tax reform proposals before you, you will keep in mind that an increase in the $1 million and $5 million industrial development bond limits can assist in reducing the balance-of-payments deficit, create jobs, and help slow inflation.

The CHAIRMAN. Now we will hear from Thomas E. Bundy, treasurer, American Industrial Development Council.

STATEMENT OF THOMAS E. BUNDY, TREASURER, AMERICAN INDUSTRIAL DEVELOPMENT COUNCIL

Mr. BUNDY. I am Thomas E. Bundy, and I am representing the American Industrial Development Council and its affiliated regional councils, which represent close to 5,000 area industrial, economic developers, or whatever you might want to call us. These are people who work at the community, regional, and State levels to create jobs for their given areas.

One of their most successful tools, which they have used over the past 30 years, has been the so-called industrial development bond. This program is now being used successfully both in the cities and in the rural areas. It helps expand industry, and preserve industry where it exists.

In my own area, which is northwestern Pennsylvania, 95 percent of the projects are not new industry coming in, but the expansion and preservation of the industry already there.

Now, as the corporate witnesses have testified, because of inflation—we are here to talk only about inflation this morning. Inflation is actually stifling the program, because what was a reasonable limit back in 1968, today is a total unrealistic limit. This program is slowly coming to a halt, unless we get relief from the effect of inflation.

This is why we endorse what has been suggested to you this morning, that the House bill be changed, where it says $10 million, to raise that to $15 million, and to raise the $1 million to $3 million, which would not be subject to the capital expenditures rule.

I was impressed, Mr. Chairman, with your comment on the trouble you are having between what you hear on what costs and does not cost the Treasury. Our association has produced a publication which once and for all proves conclusively that this program actually created, in the long run, new revenues for Treasury.

We are not talking about what some computer said would happen in the year 1990. We are talking about what has actually happened by a study of seven States. With your permission, I will send you a copy, and I will write to your joint committee and send them a copy, because I am sure that it will help you.

I can see that you are torn between all these claims, and you will be interested in this publication.

In conclusion, I would like to say: You give us this relief from the effect of inflation, and we will go back home to our own areas and produce the jobs for you.

Thank you.

The CHAIRMAN. We ought to be able to find some way to take credit for the money that the Government spends on this funding, as well as what the Government picks up in taxes when you reduce unemployment, when you preserve or increase property value in the community, and reduce welfare, and food stamps, and things like that, by putting the people to work.

If you take those things into account, as we definitely should, and create these new jobs, it will have a big feedback that some of the people over the Department of the Treasury do not want to admit. We ought to take all of these things into consideration.

Senator Danforth?

Senator DANFORTH. I have no questions, Mr. Chairman.

Mr. SIEMSEN. We limited our testimony so that Mr. Herschel Friday could make a brief statement, on behalf of the Marmon Group.

The CHAIRMAN. You have 2½ minutes.

STATEMENT OF HERSCHEL FRIDAY, ON BEHALF OF THE MARMON GROUP

Mr. FRIDAY. I do have a prepared statement that has been filed on behalf of the Marmon Group, Inc. In addition to that statement, I would like to emphasize a couple of things. I have had a background of about 18 years working with small issue IDB's and I have worked with some 100 of them around the country. Let me emphasize this: It is a working program that is getting the job done. Small issue IDB's are being utilized by companies throughout the country. You have heard the testimony this morning that the market has adjusted to it, the regional investment houses have acclimated and small issue IDB's are accomplishing their intended purpose by stimulating economic development and creating new jobs.

Further, it has been my observation that the use of small issue IDB's spur local participation which is so important in developing that atmosphere that you ought to have for proper industrial development, for the relationship between the company and the local officials. You really cannot get this any other way, because you can get rather intimately acquainted with what a company is going to do and who the people are who are coming down, if you sit down and negotiate some agreements with them.

Finally, I would like to comment upon an example of the effects which the usage of small issue IDB's has upon the used companies. The Marmon Group, Inc., for example, has used IDB's some 32 times, in doing so that corporation has created 2,800 jobs and generated a $126 million annual payroll. Marmon was not dealing in theory, the location of its plants are in large part determined by the availability of small issue IDB financing.

One other point, the President or the administration, at least in his tax reform proposal, has recognized small issue IDB's as a useful vehicle to stimulate industrial development. However, the administration would limit their usage to "economically distressed areas." This has not been commented on today, at least in the oral testimony here, and it is so important. If you do adopt the administration's proposal, I think that it will affect and maybe kill the small issue IDB program.

Thank you very much.

The CHAIRMAN. Mr. Danforth.

Senator DANFORTH. Thank you, Mr. Chairman. I have just one question.

The limit that was set in 1968, Do you know what the general inflation increase has been since 1968?

Mr. OZAN. It has been 220 percent.

Senator DANFORTH. In general, what is it, 1.5 times the general revenue budgets in construction?

Mr. POTTS. Our calculations, Senator, have been that inflation now has made it necessary to spend 2½ as much on plants and equipment to achieve the same results that were achieved in 1968. This is according to last year's figures. It is stated in the prepared testimony of Emerson Electric.

Senator DANFORTH. Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

[The preparel statements of the preceding panel follow:]

STATEMENT OF RICHARD H. SIEMSEN, CORPORATE TAX DIRECTOR, EMERSON ELECTRIC CO.

Mr. Chairman and members of the Committee, my name is Richard H. Siemsen and I am Corporate Tax Director of Emerson Electric Co. With me this morning is our outside counsel, Ramsay D. Potts, of Shaw, Pittman, Potts & Trowbridge here in Washington. Emerson is a publicly held company principally engaged in the manufacture and sale of a broad range of electrical and electronic products and systems for commercial, industrial, military and consumer use. I am appearing today for Emerson to urge this Committee to increase the tax exempt limits on small issue industrial development bonds. Emerson seeks an increase of the present $1,000,000 exempt limit, which is not subject to the capital expenditures limitation, to $3,000,000, and an increase from $5,000,000 to $15,000,000 of the exemption subject to the so-called capital expenditures limitation. The $1,000,000 limit is often referred to as the "clean" limit, and I will use that shorthand term here.

Small issue industrial development bonds, or "small issue IDBs" are bonds issued by states or municipalities for the purpose of acquiring or building industrial or commercial facilities. The bond issuers lease or sell these facilities to private companies at a price sufficient to amortize and pay debt service on the bonds. Under present section 103(b)(6) of the Internal Revenue Code, interest on these bonds is exempt from federal income tax if the face amount of the total bond issue, of which a particular IDB forms a part, does not exceed $5,000,000, including certain "capital expenditures" made during a six-year period. That is, the $5,000,000 exempt amount includes not only the face amount of the bond issue, but also the amount of any capital expenditures the user of the IDB-financed facility may make with respect to that facility or other facilities in the same vicinity during a six-year period beginning three years before the bond issue date and ending three years thereafter. As a result of the so-called "capital expenditures limitation," IDBs cannot, as a practical matter, be issued in the full amount of the $5,000,000 exempt limit. IDBs issued as part of a bond issue having an aggregate face amount not in excess of the "clean" $1,000,000 limit, qualify for a tax exemption without regard to the capital expenditures limitation.

During the past thirty years, Emerson Electric has used the proceeds of numerous issues of tax-exempt small issue industrial development bonds to build new plants, expand existing plants and to acquire additional machines and equipment. Emerson Electric first used the proceeds of an IDB issue to finance a new plant in Tupelo, Mississippi in 1948. Since that time, Emerson has financed 23 more new plants with small issue IDB proceeds, and has used 11 other issues of small issue IDBs to finance plant expansion and new machinery. These financings have taken place in 18 different states.

The availability of IDB proceeds to finance capital investment has led Emerson to undertake more substantial expansions of productive capacity than the dollar amount of Emerson's IDB financing would indicate. The average amount of each of the IDB issues used by Emerson over the years has been $2,381,212, whereas by September 30, 1977, Emerson's average total investment in each facility to which the IDB proceeds were applied, equalled $6,207,789. In short, in Emerson's experience the tax exemption for small issue IDB interest has provided an effective incentive for industrial and economic expansion by reducing the interest cost of borrowed "seed money."

The tax exemption for IDB interest has also benefited the municipal issuers of IDBs inasmuch as IDB financing has encouraged the creation of new jobs and thereby stimulated the local economies. The facilities that Emerson has financed with small issue IDBs employed approximately 6,300 workers when first built or expanded. Those facilities now employ more than 14,500 workers.

The IDB issues that Emerson utilized to finance these facilities were issued by municipalities ranging in population from 2,500 to almost 200,000 located, as we stated previously, in 18 different states. The majority of the issuers had populations of 11,000 or fewer at the time of the 1970 census. In many communities of this size, Emerson has found that a significant number of workers are available, who in the past would have found employment in agriculture. In fact, leaders of many of these communities have informed us on a number of occasions that without industrial development, their communities will continue to experience an economically devastating migration of their young people to the big cities due to a lack of jobs at home. In my role as Corporate Tax Director of Emerson, I have talked with members of many local industrial development commissions who have stated unequivocally, that because of the steady and continuing decrease in agricultural employment, industrial expansion in their respective communities is essential to the communities' economic survival.

In addition to these direct benefits afforded by small issue IDBs, the bonds have incidentally benefited their municipal issuers by involving them in the process of industrial development in their respective communities. The availability of IDB financing has served to focus the attention of community leaders on the factors to be considered in planning the industrial development of the communities, and has provided a vehicle for community participation in and control of the industrial development process. Many communities have been encouraged by the prospect of issuing IDBs to set up local industrial development commissions that not only plan and carry out the issuance of IDBs, but also generally direct the industrial development of the communities. In this way, IDB financing has resulted in a more effective and environmentally compatible development of industrial areas in the issuing municipalities.

In recent years, Emerson has encountered increasing difficulties in effectively utilizing small issue IDBs due to the combined effects of inflation and the capital expenditures limitation. We have also noted the development of a groundswell of support in the corporate community in favor of legislative action to increase the exempt IDB limits to a usable level. In light of the critical need to expand productive capacity and modernize facilities, Emerson wholeheartedly concurs in this view.

Congress established the present small issue IDB limits of $1,000,000 and $5,000,000 in 1968. According to every available construction cost index, costs of commercial and industrial facilities have more than doubled since that time. The Engineering News-Record index lists costs of building construction and general construction in 1977 as 228.6% and 239%, respectively, of comparable costs in 1967. Moreover, the Wholesale Price Index lists a more than 200% increase in the costs of machine tools since 1967. Copies of our statistical sources are attached hereto as Appendix A. Using a rough average of these figures, it is obvious that the present exempt limits on small issue IDBs should be at least trebled, to restore the incentive value of the bonds to the level contemplated by Congress in 1968 and to maintain that level against the effects of inflation for at least the next few years. Emerson, therefore, urges the Congress to increase the $1,000,000 "clean limit" to $3,000,000 and to increase the $5,000,000 limit subject to the capital expenditures rule to $15,000,000. Any lesser increase, such as the increase from $5,000,000 to $10,000,000 that would be provided by section 321 of H.R. 13511, of course would improve matters, but it would not adjust for the post-1968 inflation and keep pace with rising costs of commercial and industrial construction in the immediate future.

The limit increases that we propose will benefit the nation as they benefit industry by facilitating capital formation and stimulating capital investment.

Students and critics of this nation's economy agree that a nationwide expansion of productive capacity is sorely needed. According to a study prepared by the Congressional Budget Office in August 1976 entitled, Sustaining a Balanced Expansion, the growth rate in the amount of private plant and equipment (excluding pollution control investments) in the United States declined from 4.8 percent per year in the period 1965–70 to 3.8 percent per year in 1970–75. The rate was expected to decline further to 2.5 percent per year in the period 1975–77. During the recent hearings that the Ways and Means Committee held on the Administration's tax reform proposals, representatives of private industry and IDB issuers presented abundant and well-documented testimony to the effect that small issue IDBs can effectively stimulate investment and job creation. Congress should seize this opportunity to restore this historically proven method of providing an effective incentive for capital formation and job creation.

It should be recognized, that our proposals are in fact, compatible with the Administration's objectives of reducing unemployment in "economically distressed areas." Department of Agriculture statistics demonstrate a consistent decline in the agricultural labor force over the last ten years. Such employment has declined from 4,903,000 workers in 1967 to 4,152,000 in 1977. As noted above, this decline in the agricultural labor force has certainly resulted in the migration of many rural residents to our large metropolitan areas. This flow of rural residents into the cities has contributed to urban problems in several ways. For example, if the migrating worker finds permanent employment in a city, that worker has reduced the availability of employment for a city resident. If the city resident is consequently, unable to find work in the urban area, that resident will likely join the swelling number of individuals on the city's unemployment and welfare rolls. Conversely, if the migrating worker cannot find permanent employment in the city, that worker will likely file for unemployment compensation and welfare payments in the urban area.

As we have shown above, our proposal would result in the reduction of the migration of former agricultural workers to our large metropolitan areas by providing job opportunities in industry in their local communities. The creation of such new jobs will benefit not only the local communities, but also our major metropolitan areas, by acting to alleviate the alarming trend in urban unemployment levels.

Finally, Emerson wishes to remind the Committee, as it considers the revenue impact of our proposal, that IDB-financed facilities generate Federal revenues in the form of income and FICA taxes on the wages of workers employed in the IDB-financed facilities and, to the extent that a corporation incurs a lower interest expense on borrowed capital as a result of the exempt status of IDB interest, additional amounts of federal income tax will be paid by the corporation itself. A recent statistical study by Drs. John A. Andrews and Dennis R. Murphy of Emory University, entitled, The Interest Tax-Exemption on Industrial Development Bonds: The Cost to the United States Treasury, illustrates this point. In that study, published by the American Industrial Development Council, the authors demonstrate that these IDB-generated taxes serve to offset the amount of foregone Federal income tax on the IDB interest, and will, in many cases, yield a net tax benefit to the Federal Treasury. The Committee should also note, that the IDB-financed projects generate additional state tax revenues as well.

For all the reasons stated Emerson respectfully requests this Committee to increase the clean limit on exempt small issue industrial development bonds to $3,000,000, and to increase the limit subject to the capital expenditures rule to $15,000,000. Enactment of this proposal will stimulate the economy by encouraging investment and creating new jobs, and will generate increased tax revenues for the federal and state governments.

NO. 1824.—PRICE AND COST INDEXES FOR CONSTRUCTION AND SELECTED COMPONENTS OF CONSTRUCTION: 1960 TO 1976

[1967 = 100. Excludes Alaska and Hawaii, except as noted. Indexes of certain of these firms are published on bases different from those shown here. See Historical Statistics, Colonial Times to 1970, series N 118–137, for construction cost indexes on a 1947–49 base.]

Item	1960	1965	1970	1971	1972	1973	1974	1975	1976
Price index for new one-family houses sold[1]	(NA)	93.2	117.4	123.2	131.0	144.8	158.1	174.3	191.4
Dept. of Agriculture, Economic Research Service:									
Farm construction, exc. housing	91	93	118	126	136	154	(NA)	(NA)	(NA)
Indexes of building materials prices and union wage scales:									
Wholesale prices of construction materials[2]	95.5	95.8	112.5	119.5	126.6	138.5	160.9	174.0	187.7
Union hourly wage scales in the building trades[3]	75.4	90.9	128.8	144.0	153.2	160.8	173.4	188.3	200.5
Construction cost indexes:									
Dept. of Commerce composite[4]	83	93	122	131	139	152	173	189	198
Federal Highway Administration: Highways[5]	80.0	90.3	125.6	131.7	138.2	152.4	201.8	203.8	199.3
Environmental Protection Agency:									
Sewers	85.4	93.7	120.4	134.3	149.1	160.4	183.5	208.0	221.0
Sewage treatment plant	87.9	93.8	120.3	133.8	144.0	152.9	180.6	209.4	219.7
Interstate Commerce Commission: Pipeline	101	97	109	117	122	130	154	190	200
American Appraisal Company: Building construction[6]	80	91	124	138	151	167	177	189	206
E. H. Boeckh, building cost index:[7]									
Small residential structures	81.8	90.4	122.4	132.8	145.8	159.2	172.0	183.5	198.6
Apartments, hotels, and office buildings	80.3	90.7	124.4	135.0	145.4	154.5	168.4	185.0	199.6
Commercial and factory buildings	80.4	90.0	123.1	133.9	144.8	154.4	172.0	188.8	294.9
Engineering News-Record:[8]									
Building construction	83.3	93.3	124.4	140.5	155.2	168.4	178.3	193.3	210.9
General construction	76.9	90.8	128.9	146.8	163.0	176.5	188.2	205.7	223.4
Turner Construction Company: Building construction[9]	85	94	129	143	154	162	188	198	202
Handy-Whitman public utility:[10]									
Building	87	93	121	133	144	158	190	213	217
Gas plant	85	94	117	125	134	140	160	(NA)	(NA)
Electric light and power[11]	89	94	119	128	135	144	171	201	214

NA-Not available. [1] Includes value of site.

[2] Covers materials incorporated as integral part of a building or normally installed during construction and not readily removable. Excludes consumer durables, such as kitchen ranges, refrigerators, etc. For 1960, excludes Alaska and Hawaii. Source: U.S. Bureau of Labor Statistics, "Wholesale Prices and Price Indexes," annual.

[3] Based on minimum wage rate agreed upon through collective bargaining; excludes overtime. As of July 1. Source: U.S. Bureau of Labor Statistics, "Union Wages and Hours: Building Trades," annual.

[4] Covers both building and nonbuilding construction, excluding maintenance and repair. Represents a weighted average of various indexes used for different types of construction.

[5] Based on average contract unit bid prices for composition mile (involving specific average amounts of excavation paving, reinforcing steel, structural steel, and structural concrete).

[6] Average for 30 cities of 4 types of buildings: Wood-frame, brick-wood frame, brick-steel frame, and reinforced concrete. Covers materials and labor costs in structural portion of buildings but excludes those for plumbing, heating, lighting, sprinklers, and elevators. Reflects employee-benefit costs, and allows for contractors' overhead and profit.

[7] Average of 20 cities for types shown. Weights based on surveys of building costs. Wage rates used for both common and skilled labor. Reflects payment of sales taxes and social security payroll taxes.

[8] Building construction index computed on basis of hypothetical unit of construction requiring 6 bbl. of portland cement, 1,088 M bm of 2" x 4" lumber, 2,500 lb. of structural steel, and 68.38 hr of skilled labor. General construction index based on same materials components combined with 200 hr of common labor.

[9] Eastern cities. Based on firm's cost experience with respect to labor rates, materials prices, competitive conditions, efficiency of plant and management, and productivity. Reflects payment of sales taxes and employee-benefit costs.

[10] Based on data covering public utility construction costs for 95 items in 6 geographic regions. Covers skilled and common labor; does not reflect tax payments nor employee-benefit costs.

[11] As derived by U.S. Bureau of the Census. Covers steam production plants only; excludes hydraulic plants.

Source: Except as noted, U.S. Bureau of the Census. In U.S. Bureau of Domestic Commerce, "Construction Review."

TABLE E-1.—CONSTRUCTION COST INDEXES
[1972 = 100]

Period	Department of Commerce composite cost index[1]	American Appraisal Company	"Boeckh Indexes," The American Appraisal Co., Inc.: Residences	"Boeckh Indexes," The American Appraisal Co., Inc.: Apartments, hotels, and office buildings	"Boeckh Indexes," The American Appraisal Co., Inc.: Commercial and factory buildings	Engineering News-Record: Building	Engineering News-Record: Construction	Environmental Protection Agency: Sewers	Environmental Protection Agency: Plant
	Annual averages								
1972	100.0	100	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1973	108.4	111	109.2	105.9	106.6	108.5	108.3	107.5	106.2
1974	126.1	117	118.0	115.8	118.1	114.9	115.5	124.2	126.3
1975	138.2	125	125.9	127.2	130.4	124.5	126.2	139.5	145.3
1976	143.5	137	136.2	137.3	141.5	135.9	137.1	148.2	152.5
	Monthly indexes		Bimonthly indexes			Monthly indexes		Quarterly indexes	
1976:									
January	140.4	132	130.5	131.8	135.4	129.9	131.4	143.9	149.2
February	140.3	132				130.7	132.0		
March	140.6	133	131.6	133.7	138.5	131.4	132.3		
April	141.7	134				132.5	132.9	147.3	150.9
May	142.7	135	135.9	137.4	141.8	133.2	134.6		
June	143.6	137				135.0	137.6		
July	143.9	139	137.7	138.5	142.7	136.0	137.9	149.2	152.6
August	144.4	139				138.8	139.6		
September	144.5	140	139.0	139.5	143.7	139.9	140.8		
October	145.3	140				140.8	141.5	152.5	157.2
November	146.1	140	142.9	142.6	147.0	141.0	142.0		
December	146.9	140				141.6	142.2		
1977:									
January	149.0	141	143.3	143.6	147.8	142.0	142.5	153.5	157.5
February	150.5	141				143.0	143.1		
March	150.9	142	145.3	146.3	150.1	143.4	143.6		
April	152.7	143				143.6	143.6	155.2	159.2
May	154.4	144	147.0	147.8	151.6	143.7	143.6		
June	156.2	145				145.1	145.1		
July	[2] 155.2	147	149.9	149.9	154.2	146.8	147.3	159.5	163.4
August	[2] 157.1	149				148.2	149.1		
September	[2] 158.4	150	152.2	151.5	155.7	151.4	151.0		
October	157.9	150				154.4	152.8		
November	159.7	151	153.2	152.5	157.5	153.0	151.9		
December						153.3	152.5		

Period	Federal Highway Administration: Structures	Federal Highway Administration: Composite	Bureau of the Census new 1-family houses excluding census lot value	Bureau of Reclamation	Turner Construction Co.	Handy-Whitman public utility: Buildings	Handy-Whitman public utility: Electric light and power	Bell system telephone plant, telephone and telegraph: Buildings	Bell system telephone plant, telephone and telegraph: Outside plant	Interstate Commerce Commission pipeline
	Annual averages									
1972	100.0	100.0	100.0	100	100	100	100	100.0	100.0	100
1973	111.3	110.3	109.5	106	107	109	107	107.4	104.6	106
1974	152.6	146.0	120.8	119	124	132	127	123.0	120.5	126
1975	149.7	147.5	131.6	139	129	147	149	[2]138.6	129.9	155
1976	140.5	144.2	141.1	149	132	150	158	[2]147.7	141.1	163
	Quarterly indexes					Semiannual indexes		Annual indexes		
1976:										
1st quarter	141.7	144.9	136.2	146	130	145	153	147.7	141.1	163
2d quarter	144.5	145.0	140.0	147	131					
3d quarter	134.9	144.0	142.6	150	133	150	159			
4th quarter	142.5	145.0	146.8	152	133					
1977:										
1st quarter	147.7	146.3	151.5	154	134	153	163			
2d quarter	148 2	155.9	157.3	156	135					
3d quarter	140.0	156.2	159.6	159	137					
4th quarter				161	139					

[1] An implicit price deflator, computed by the Bureau of the Census, which is the ratio of the estimate of total new construction put in place in current dollars (seasonally adjusted) to the corresponding estimate in 1967 dollars. In form, the index is a weighted harmonic mean of the deflators used for various categories of construction (and, hence, of the basic cost indexes which make up these deflators), which weights proportionate to the value-put-in-place estimates (seasonally adjusted) for these categories. Since this "implicit price deflator" is in the form of a changing weight index, it measures the combined result of cost changes as well as monthly changes in the weights of different types of construction in the current-dollar construction activity aggregate. Sources as stated.

[2] Revised.

TABLE E-1. SUPP. 1—DEPARTMENT OF COMMERCE COMPOSITE COST INDEXES: 1964-76

[1972=100]

Year	Annual composite index	Month: January	February	March	April	May	June	July	August	September	October	November	December
1964	65.9	65.6	65.3	65.3	65.4	65.7	65.8	65.8	65.9	66.0	66.2	66.4	66.5
1965	67.2	66.7	66.7	66.6	66.6	66.8	66.9	67.1	67.4	67.6	67.8	67.9	68.1
1966	69.8	68.3	68.3	68.5	69.6	70.2	70.4	70.3	70.2	70.1	70.3	70.3	70.5
1967	72.4	71.0	71.5	71.7	71.8	71.9	72.4	72.5	72.7	73.0	73.0	73.3	73.5
1968	76.1	74.6	75.2	75.7	75.6	75.6	76.1	75.8	76.1	78.6	78.5	77.1	77.9
1969	82.7	79.4	80.7	81.7	81.8	82.2	82.2	83.2	83.5	84.2	84.2	84.3	84.2
1970	88.3	85.4	86.0	86.8	87.6	88.3	89.6	89.1	88.9	89.1	88.9	88.9	89.4
1971	94.5	90.5	92.3	93.5	93.5	93.9	94.5	94.7	95.9	95.8	95.4	95.4	96.4
1972	100.0	97.9	98.4	98.8	98.7	98.9	99.1	99.7	100.7	101.5	101.7	102.1	102.5
1973	108.4	102.9	104.2	104.9	106.7	107.3	107.7	108.8	110.4	111.3	111.4	111.5	111.6
1974	126.1	115.2	118.0	121.1	122.1	124.1	126.4	128.9	130.5	132.1	131.3	130.6	130.5
1975	138.2	135.1	137.1	138.1	137.4	137.8	138.0	138.2	138.2	139.7	139.0	139.1	139.8
1976	143.5	140.4	140.3	140.6	141.7	142.7	143.6	143.9	144.4	144.5	145.3	146.1	146.9

WAGE PRICE INDEXES FOR INDUSTRIAL MACHINERY

[OBTAINED FROM BUREAU OF LABOR STATISTICS]

Year	Annual average	January	Feburary	March	April	May	June	July	August	September	October	November	December
						Metal-forming machine tools							
1967	100.0	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1968	104.1	NA	NA	NA	NA	NA	NA	MA	NA	NA	NA	NA	NA
1969	107.4	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1970	115.6	113.6	113.6	113.6	112.7	116.3	116.3	116.6	116.6	116.6	116.9	116.9	117.2
1971	123.1	117.2	120.6	120.6	120.6	124.1	124.8	124.8	124.8	124.8	124.9	126.9	125.5
1972	125.3	123.6	124.0	124.9	124.9	124.8	124.9	125.0	125.2	125.8	126.6	126.7	126.7
1973	133.0	126.7	127.5	130.0	131.8	132.7	133.3	133.3	133.3	135.3	136.8	137.1	138.1
1974	161.7	142.4	143.1	147.6	151.4	155.6	156.9	164.4	167.1	175.1	177.9	179.1	180.3
1975	192.2	181.7	184.2	185.2	186.2	187.5	192.7	193.6	193.6	194.4	201.8	202.3	202.8
1976	212.9	206.2	206.6	207.4	208.7	212.7	214.6	214.9	215.5	216.5	216.9	217.4	217.6
1977	232.9	220.2	221.7	223.0	223.7	226.2	235.1	236.3	238.1	240.2	NA	NA	NA
						Metal-cutting machine tools							
1967	100.0	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1968	103.0	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1969	106.9	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1970	113.5	110.7	111.1	111.7	111.8	112.4	113.5	114.3	114.3	115.4	115.4	115.7	116.1
1971	117.2	116.7	116.9	117.1	117.0	116.6	116.8	117.3	118.0	117.6	117.6	117.6	117.7
1972	120.2	117.9	118.5	118.8	119.4	120.1	120.3	120.6	121.0	121.4	121.4	121.4	121.5
1973	128.2	123.1	124.1	125.0	126.6	127.7	128.1	128.6	128.6	129.7	131.0	132.0	133.9
1974	152.0	136.3	137.9	140.5	143.4	148.8	151.1	153.4	156.7	159.9	163.5	165.5	167.2
1975	177.1	168.9	170.1	172.2	174.3	176.0	176.7	178.1	179.2	180.6	181.5	183.6	184.4
1976	191.0	185.6	186.0	187.2	189.1	190.0	190.7	191.3	192.0	192.7	193.9	195.6	197.6
1977	206.2	198.4	199.1	200.2	201.9	202.7	205.5	206.0	207.8	210.0	NA	NA	NA

NA—Not available.

STATEMENT OF AMERICAN GREETINGS CORP.

Mr. Chairman and members of the Committee, my name is Paul H. Ozan and I am Assistant General Counsel and Assistant Secretary of American Greetings Corporation. American Greetings Corporation is a publicly-held corporation principally engaged in the manufacture and sale of greeting cards, gift wrappings and display fixtures. I am appearing today for American Greetings to urge this Committee to increase the tax exempt limits on the issue amounts of small issue industrial development bonds from $5,000,000 to $15,000,000, subject to the so-called capital expenditures limitation. American Greetings also seeks an increase of the present $1,000,000 exempt limit, which is not subject to the capital expenditures limitation, to $3,000,000. The $1,000,000 limit is often referred to as the "clean" limit, and I will use that shorthand term here.

Small issue industrial development bonds, or "small issue IDB's," are bonds issued by states or municipalities for the purpose of acquiring or building industrial or commercial facilities. The bond issuers lease or sell these facilities to private companies at a price sufficient to amortize and pay debt service on the bonds. Under present section 103(b)(6) of the Internal Revenue Code, interest on these bonds is exempt from federal income tax if the face amount of the total bond issue of which a particular IDB forms a part does not exceed $5 million, including certain "capital expenditures" made during a six-year period. That is, the $5,000,000 exempt amount includes not only the face amount of the bond issue, but also the amount of any capital expenditures the user of the IDB-financed facility may make with respect to that facility or other facilities in the same vicinity during a six-year period beginning three years before the bond issue date and ending three years thereafter. As a result of this so-called "capital expenditures limitation," IDB's cannot, as a practical matter, be issued in the full amount of the $5,000,000 exempt limit. IDB's issued as a part of a bond issue having an aggregate face amount not in excess of the "clean" $1,000,000 limit qualify for tax exemption without regard to the capital expenditures limitation.

During the past 17 years, American Greetings has used the proceeds of numerous issues of tax-exempt small issue industrial development bonds to build new plants, expand existing plants and to acquire additional machinery and equipment. American Greetings first used the proceeds of an IDB issue to finance a new plant in Osceola, Arkansas, in 1960. Since that time, American Greetings has financed 11 more new plants with small issue IDB proceeds. In all instances, the plant site location selected was determined by a very careful analysis of the labor supply available. These were areas wherein the basic employment opportunities were agriculture or agriculturally oriented. The locations had seen a steady exodus of their young people to the larger cities due to the lack of job opportunities. In all instances, this trend was reversed with the introduction of a new industrial facility. The U.S. Department of Commerce has estimated that the creation of 100 industrial jobs creates 65 additional service jobs. Thus, the impact of an industrial facility employing three to four hundred people can be quite dramatic to a small community and the labor force area surrounding it.

The availability of industrial development bonds is of prime importance to companies in the creation of new jobs. A publication entitled "Statistical Abstract of Long-Term Municipal Bond Dollar Volume—Jan. 1970–Sept. 1976" prepared for the American Industrial Development Council, Inc., by James G. Belch indicates that the net public indirect cost of each job created by an industrial development bond in 1975 was only $3,727. In the case of American Greetings, total domestic employment in 1960 was 2,622. At the end of 1977, domestic employment was 12,780—an increase of 10,158 jobs. All space expansion was financed through $41,800,000 of industrial development bonds. If we assume that the average taxable interest that would have been paid was 7.5 percent and the bonds were issued in an even progression so as to have an average amount outstanding of $20,900,000 for the 17 years and with a tax rate of 50 percent (20,900,000x17x .075x.5) the net public indirect cost of each of the 10,158 jobs created was $1,311.65. Compare this to previously proposed direct federally subsidized job programs costing 5 billion dollars to create 130,000 jobs, or $38,461.54 per job.

In addition to these direct benefits afforded by small issue IDB's, the bonds have incidentally benefited their municipal issuers by involving them in the process of industrial development in their respective communities. The availability of

IDB financing has served to focus the attention of community leaders on the factors to be considered in planning the industrial development of the communities, and has provided a vehicle for community participation in and control of the industrial development process. Many communities have been encouraged by the prospect of issuing IDB's to set up local industrial development commissions that not only plan and carry out the issuance of IDB's but also generally direct the industrial development of the communities. In this way. IDB financing has resulted in a more effective and environmentally compatible development of industrial areas in the issuing municipalities.

In recent years American Greetings has noted a marked decline in the usefulness of small issue IDB's due to the combined effects of inflation and the capital expenditures limitation. We have also noted the development of a groundswell of support in the corporate community in favor of legislative action to increase the exempt IDB limits to a useable level. American Greetings wholeheartedly concurs in this view.

Congress established the present $5,000,000 and $1.000,000 limits in 1968. According to every available construction cost index, costs of commercial and industrial construction have more than doubled since that time. The Engineering News-Record index lists costs of building construction and general construction in 1977 as 228.6 percent and 239.9 percent, respectively, of comparable costs in 1967. Moreover, the Wholesale Price Index lists a more than 200 percent increase in the costs of machine tools since 1967. Using a rough average of these figures, it is obvious that the present exempt limits on small issue IDB's should be at least trebled to restore the incentive value of the bonds to the level contemplated by Congress in 1968 and to maintain that level against the effects of inflation for at least the next few years. American Greetings therefore urges the Congress to increase the clean $1,000,000 limit to $3,000,000 and to increase the $5,000,000 limit subject to the capital expenditures rule to $15,000,000. Any lesser increase, such as the increase from $5,000,000 to $10,000,000 that would be provided by section 321 of H.R. 13511. of course would improve matters, but it could not adjust for the post-1968 inflation and keep pace with rising costs of commercial and industrial construction in the immediate future.

The limit increase that we propose will benefit the nation as it benefits industry by facilitating capital formation and stimulating capital investment. Students and critics of this nation's economy agree that a nationwide expansion of productive capacity is sorely needed. According to a study prepared by the Congressional Budget Office in August, 1976, entitled Sustaining a Balanced Expansion, the growth rate in the amount of private plant and equipment (excluding pollution control investments) in the United States declined from 4.3 percent per year in the period 1965–70 to 3.3 per cent per year in 1970–75. The rate was expected to decline further to 2.5 per cent per year in the period 1975–77. During the recent hearings that the Ways and Means Committee held on the Administration's tax reform proposals, representatives of private industry and IDB issuers presented abundant and well-documented testimony to the effect that small issue IDB's can effectively stimulate investment and job creation. Congress should seize this opportunity to restore this investment incentive to its original strength.

Finally, American Greetings wishes to remind the Committee, as it considers the revenue impact of our proposal, that IDB-financed facilities generate Federal revenues in the form of income and FICA taxes on the wages of workers employed in the IDB-financed facilities and, to the extent that a corporation incurs a lower interest expense on borrowed capital as a result of the exempt status of IDB interest, additional amounts of federal income tax will be paid by the corporation itself. A recent statistical study by Drs. John A. Andrews and Dennis R. Murphy of Emory University. entitled "The Interest Tax-Exemption on Industrial Development Bonds: The Cost to the United States Treasury," illustrates this point. In that study, which was published by the American Industrial Development Council. the authors demonstrate that these IDB-generated taxes serve to offset the amount of foregone Federal income tax on the IDB interest and will, in many cases, yield a net tax benefit to the Federal Treasury. The Committee should also note that the IDB-financed projects generate additional state tax revenues as well.

For all the reasons stated, American Greetings respectfully requests this Committee to increase the clean limit on exempt small issue industrial development bonds to $3,000,000 and to increase the limit subject to the capital expenditures rule to $15.000,000. Enactment of this proposal will stimulate the economy by encouraging investment and creating new jobs, and will generate increased tax revenues for the federal and state governments.

STATEMENT OF SOUTHWIRE CO., CARROLLTON, GA.

Mr. Chairman and honorable members of he Senate Finance Committee, I wish to thank you for the opportunity to submit this statement to the Committee concerning "small issue" Industrial Development Bonds ("IDBs") as governed by § 103(b) of the Internal Revenue Code and the vital role they can play in our Nation's economy. We believe this is a matter that deserves your careful consideration in connection with your deliberations concerning new tax legislation.

My name is James Stone, and I am the Manager, Planning and Venture Analysis of Southwire Company. By way of introduction, I would like to give you some background information concerning Southwire. Southwire is headquartered in Carrollton, Georgia, about 50 miles west of Atlanta. We organized Southwire in 1950 with $80,000 of capital investment and it has grown over the years, through the application of hard work, ingenuity, advanced technology and superior service to its customers, to an operating sales level in excess of $515 million in 1977.

We have built and acquired manufacturing facilities in Kentucky, Arkansas, Connecticut, New Jersey and Illinois as well as in Georgia. We have traditionally placed our plants in areas lacking industrial capacity. As a result, our presence has always contributed to greater economic well-being and the development of new jobs. In the past, IDB financing contributed greatly to this successful growth program.

We have had to curtail our growth in recent years, however, as well as many, if not all, of our plans for further expansion in the United States due to the scarcity of capital funds. This scarcity has resulted in part from the inadequacy of the Industrial Development Bond program, and that inadequacy has come about due to the restrictions that were placed on Industrial Development Bond financing in 1968 which I will discuss in greater detail below. I might insert parenthetically here that although our company has a good earnings record, we have yet to pay the first dividend to our common shareholders. All of our profits for 27 years have been plowed back into further growth.

We have always experienced great difficulty in finding adequate capital to finance the expansion of our operations. While our growth over the past 27 years, as outlined above, is a dramatic example of what the American dream can be, we are relatively small in our industry. Our major competitors are industrial giants such as Alcoa, Kaiser, Reynolds Aluminum and Anaconda. We are in a constant battle for survival with those companies. It is my belief that competition is the lifeblood of our Nation's development as the leading civilization in the world, and the ability of small companies such as ours to compete must not be smothered. That ability to compete is diminishing every day though—as is the likelihood of new entrants into all industrial markets—because smaller companies have such great difficulty in obtaining capital. Southwire, and all companies similarly situated or smaller, are at a tremendous competitive disadvantage in obtaining money for capital expansion. The industrial giants have ready access to, and great influence in, Wall Street and the other major money markets of the world. Consequently, they can obtain money at substantially lower interest rates than those available to smaller companies when, or if, money is available to the small companies and businesses at all.

That is a point I wish to emphasize. Over recent years, there have been many times when money for investment in capital expansion was unavailable to us, and other companies such as ours, at any interest rate, despite our excellent record. Consequently, we have been forced many times to pass up attractive opportunities for expansion—expansion that would have meant more jobs for American citizens, and a strengthening of a vigorous, imaginative small competitor. This trend cannot be allowed to continue if this Country is to retain its position of leadership in the world.

The financial tool we used most successfully in finding funds for capital expansion at Southwire until recently was the Industrial Development Bond. It enabled us, first to gain access to a broader money market that otherwise would have been unavailable to us and second, to obtain money at an interest rate more nearly equivalent to that available to the much larger companies with which we compete. Many of our facilities in Georgia and all of our facilities in Illinois, Arkansas and Kentucky would not have been possible without Industrial Development Bond financing. The Industrial Development Bond is no longer helpful to us in acquiring and building new productive facilities, through, because of the high rate of inflation we have experienced in this Country and because of the impact of certain restrictions on the use of "small issue" IDBs that were imposed in 1968.

Present law governing the use of "small issue" industrial development bonds

Under § 103 of the Internal Revenue Code of 1954, as amended (the "Code"), interest on state and local government obligations is generally excluded from gross income for tax purposes. Obligations enjoying this tax exemption can be sold for relatively lower interest rates than can obligations the interest on which is taxable. For a number of years, states and municipalities, where permitted by local laws, could issue tax-exempt bonds to acquire or build industrial facilities which they in turn leased or sold to private enterprise at a price sufficient to amortize and pay debt service on the bonds. Effectively, these private enterprises were thereby able to finance expansion at the lower interest cost of the states and municipalities. This form of financing also gave many businesses access to money markets that otherwise would have been unavailable to them. In those instances where states and municipalities found it appropriate to provide financial assistance to businesses in this manner, that assistance proved to be an effective incentive to industrial and economic expansion. Congress, however, imposed severe restrictions on this type of municipal financial assistance in 1968 with the adoption of what is now § 103(b) of the Code.

Under § 103(b), these municipal obligations issued to assist industry are called "industrial development bonds" (sometimes referred to as IDBs), and the exemption from taxation for interest on IDBs is now prohibited, with certain exceptions. One of those exceptions is the "small issue" IDB. Congress provided that the interest on IDBs would continue to enjoy the tax-exemption if the size of the bond issue were limited to $1,000,000 (hence the name "small issue" IDB).

This limitation was passed after the promulgation of proposed Treasury Department Regulations in March 1968 which would have eliminated the tax-exempt status for interest on all IDBs. The Treasury's proposed regulations were intended to correct what Treasury officials deemed to be abuses in the use of IDBs. Congress recognized, however, that, while some abuses may have existed, IDB financing served a valuable purpose by providing communities an opportunity to improve their economic base through industrial development. Accordingly, Congress adopted § 103(b)(6) to preserve the tax-exempt status of "small issue" IDBs.

Upon further study during 1968, Congress determined that the $1,000,000 limitation would not enable communities to use this method of financing as effectively as had been intended. Consequently, in October 1968, Congress amended § 103(b)(6) to provide an alternative $5,000,000 limitation. If the alternative limitation is chosen, though, the size of the bond issue plus certain "capital expenditures" cannot exceed $5,000,000.

The permitted size of tax-exempt "small issue" industrial development bonds must be increased

The $1,000,000 and $5,000,000 limitations imposed in 1968, in view of the value of a 1968 dollar, were not at that time so restrictive as to destroy the incentive that IDB's provided to industry for productive expansion. However, inflation since 1968 has almost completely eroded the value and effectiveness of "small issue" IDB's. According to every available construction cost index, costs of commercial and industrial construction have more than doubled since 1967. The Engineering News-Record index lists costs of building construction and general construction in 1977 as 228.6 percent and 239.9 percent, respectively, of comparable costs in 1967. Additionally, the Wholesale Price Index lists a more than 200 percent increase in the costs of machine tools since 1967.

At Southwire we have found that we can no longer construct or acquire a worthwhile modern facility for $5,000,000 and we know that many other industrial concerns find themselves in the same situation. Southwire has projects planned currently which cannot proceed because we have been unsuccessful in obtaining affordable financing. We could utilize IDB financing for some of those projects under the existing limitations were it not for the erosion in the dollar that has occurred due to inflation since the limitations were imposed. Therefore it is essential that limits be increased if for no reason other than the effect of inflation since 1968.

However, there is another very good reason why the limits need to be increased. Under § 103(b)(6) of the Code, "capital expenditures" made by or on behalf of the primary user of the facilities being financed by IDB's, if such expenditures are for plants located in the same municipality or county as the bond-financed facility (even if they are not made in conjunction with that facility) are credited against the alternative $5,000,000 ceiling on the size of "small issue" IDB's and thereby correspondingly reduce the amount of tax-exempt bonds that may be issued. These expenditures include any expenditures made during the six-year period beginning three years immediately preceding the date of the bond issue.

For purposes of § 103(b)(6) of the Code, the term "capital expenditures" includes any expenditures properly chargeable to the capital account of the business on whose behalf the bonds were issued, even if such expenditures otherwise could be expended. This would include such items as research and development, the purchase of equipment and machinery, the addition of new facilities and other expenditures necessary for the growth of a business.

The most significant effect of the "capital expenditure" limitation is that, as a practical matter, the limit on tax-exempt IDB financing has been closer to $4,000,000 than $5,000,000. This is due in large part to the considerations of marketing the bonds. Investors in tax-exempt bonds are not willing to take the risk of buying a bond that is part of an issue, the dollar amount of which is too close to the upper limits of the exemption because the violation of the $5,000,000 ceiling renders interest on the bonds taxable.

For example, if a facility costing $3,900,000 were financed through the use of IDB's, and immediately thereafter the company that was the principal user of the facility engaged in research costing $500,000 and purchased trucks, machinery and other equipment costing $600,000, no further "capital expenditures" could be made by the enterprise during the three years immediately following the date of the bond issue even if sound business practice impelled such expenditures.

Accordingly, we recommend that the limits be increased sufficiently to provide for a cushion for the minimal "capital expenditures" which will necessarily have to be incurred within the three-year "capital expenditure" period that remains after the bonds are issued. This would minimize investor fears that the "capital expenditure" limit might be exceeded during the three years following the bonds' issuance, thus, by law, triggering taxability of the interest paid on the IDB's previously issued. Such taxability, in turn, usually requires the redemption of the bonds at a substantial premium pursuant to the leases or loan agreements and trust indentures we enter into with the purchasers of the bonds.

It is important to note that prohibited "capital expenditures" are not limited to additional tax-exempt bond issues, but also include expenditures of money which we might be able to borrow ourselves or which we might have available in our own cash reserves. Businesses that find themselves suddenly in a fast growth situation are prevented from spending their own money to grow and further stimulate the public benefits which the IDB financing is supposed to bring about in the first place.

CONCLUSION

The expanded use of industrial development bond financing will increase rather than reduce, the money coming into the Federal coffers through an increase in individual income taxes. The industrial plant expansions redound to the benefit of the States as well as the Federal government, resulting in better schools, better roads, and generally improved municipal services which in turn create more job-producing businesses. As an example, I would like to cite briefly some statistics relating to Hancock County, Kentucky, where Harvey Aluminum (now Martin-Marietta), National-Southwire Aluminum and Southwire Company were able to use industrial development bonds in the aggregate amount of approximately $190,000,000 to build industrial facilities before the 1968 limitations were placed on industrial development bonds. While County population was increasing 33 percent from 1960 to 1970, manufacturing employment increased 375 percent, the annual industrial payroll in terms of dollars increased 794 percent from 1967 to 1974, property tax assessment increased 110 percent from 1967 to 1974, and total tax collections increased 391 percent from 1967 to 1974.

Every 100 new industrial jobs create at least 65 additional service jobs, according to U.S. Chamber of Commerce statistics. Consequently, it would be pure folly to consider only the fact that industrial development bonds do not directly produce taxable income. They produce significantly expanded Federal tax receipts through the additional jobs that result from industrial development bond-financed facilities. Additionally, we must consider all the other benefits that our Country will enjoy as a result of increased production and employment which cannot be measured in mere dollars.

Therefore, Southwire believes it necessary and beneficial to the country to restore the incentive value of "small issue" Industrial Development Bonds. The House Ways and Means Committee considered this matter and agreed that some change was needed. It proposed to increase from $5,000,000 to $10,000,000 the limit on the size of "small issue" IDB's which are subject to the capital expenditure limitation. The full House recently considered the tax bill of which this provision was a part, and approved it.

We and many others testified before the Ways and Means Committee in favor of raising the limit on the size of "small issue" IDB's to $10,000,000 and removing the restrictive capital expenditure limitation. Many people apparently believe that the capital expenditure limitation serves a beneficial purpose in restricting the use of IDB financing to projects having the greatest economic justification. Accordingly, the Ways and Means Committee and the House did not remove that restriction. So long as that restriction remains in place, however, inflation since 1968 and projections for continued inflation dictate that the limits on the size of "small issue IDB's subject to the capital expenditures restriction and those not subject to the restriction must be raised by well over 100 percent to restore and preserve, for at least a few years, the incentive to expansion of productive capacity and increased capital formation provided by "small issue" IDB's at the level intended by Congress when the limitations were imposed in 1968.

RECOMMENDATIONS

Southwire believes it is essential that the limit on the "small issue" IDB's subject to the capital expenditure limitation be increased from $5,000,000 to $15,000,000 and that the maximum limit on those bonds that are not subject to the capital expenditure limitation be increased from $1,000,000 to $3,000,000. Only through such increases can the "small issue" Industrial Development Bond regain its value as an important capital formation tool to the small to medium size, growth oriented firm.

Statement of Thomas E. Bundy on Behalf of the American Industrial Development Council

My name is Thomas E. Bundy. This statement is made on behalf of the American Industrial Development Council, an association of professional industrial developers from all states in the U.S. The daily work of these people is to create new employment in their various cities, counties, regions and states through industrial and economic expansion.

A tool that these developers have been using with growing success is the industrial development revenue bond, or IDRB, as it is commonly called. This form of industrial facility financing has produced over 40,000 new jobs annually over the past several years. We invite the members of this Committee to check with the industrial development agency in their own states as to the use of IDRB's. You will be pleased at the report given to you.

It has been charged that this program produces revenue loss to the Federal Treasury. When one thinks about the new taxes generated from 40,000 new jobs and from the corporate return of $500,000,000 of new investment each year, this argument proves to be not valid. The American Industrial Development Council has published a recent study proving conclusively that the Treasury does not lose tax revenue from this program, but actually gains. We would be glad to provide copies to all interested parties.

Users of IDRB's know that the resulting new jobs, new investment and new tax revenues would be even greater if the program was not suffering under severe limitations. Areas and states using this program need legislative relief immediately in order to permit IDRB's to reach their full potential in the creation of new jobs and new capital formation. The program works, but is being stifled by outdated dollar limits and the pressures of growing inflation.

Since the IRS Code is rather broad in its definition of IDRB's in various categories, it is well to identify exactly the category under which development agencies are having the most difficulty. Under Section 103(b)(6) of the Code, tax exemption of interest is provided to "Certain Small Issues". This provision accounts for only 1% of all municipal bonds issued, so it is no threat to other necessary forms of municipal financing. This is the section we work with to provide new jobs in our communities. A "Small Issue" is defined as one under $1,000,000. You will recognize that $1,000,000 does not go very far in building and equipping a manufacturing plant these days.

However, this Section permits a community to elect use of a provision allowing an issue to rise to $5,000,000. But, this issue would then be subject to a very restrictive capital expenditures rule. This is a very complex restriction, but its effect is to prevent a company from even spending its own funds for additional capital expansion, if the five million ceiling is used. This rule can bring about a virtual "freeze" on expansion in a given municipality.

Developers have been against this rule from its inception. It is self-defeating and without justification whatsoever. It does not control the program, it cripples it. We would like to see it removed from the Code completely.

But, we realize the Senate has many issues to examine in designing a tax bill this year. There is insufficient time now to consider thoroughly this very technical and complex rule.

The main thrust of our appeal today is to seek relief from the drastic effects of inflation on the IDRB program. This legislative relief will keep our job-producing programs going until the proper time for a complete review of the subject in the future.

The one million and five million ceilings were put into the Code by Congress in 1968 in response to well recognized abuses. Responsible economic developers across the country have always accepted the principle that realistic ceilings are necessary to prevent abuses in programs to build new plants with IDRB's. The "one" and the "five" seemed reasonable at the time.

However, the past ten years have seen construction and equipment costs rise nearly 250 percent. An examination of all the accepted construction cost indices verifies this increase. All indications point towards continuation of this trend with plant costs tripling over 1968 figures in the very near future.

A simple and logical action would be to triple the present ceilings in the Code because of past and expected cost increases. This is what we advocate as an immediate solution to the problem. We are convinced this action would mean revitalization of a proven program that now faces possible extinction.

Section 321 of the recently passed House tax bill, H.R. 13511, goes a long way towards solving the situation. It raises the existing five million limit to ten million. We consider this an absolute minimum to keep the IDRB program alive

But Section 321 does not meet the expected cost increases in the next few years, nor does it address at all, the problem of only a $1,000,000 ceiling free from the capital expenditures rule. The inflationary formula should be applied to this ceiling also.

Therefore, we urge this Committee to increase the $10,000,000 limit in Section 321 to $15,000,000 and to add a provision that will increase the $1,000,000 limit on certain small issues to $3,000,000.

Then, the nearly 5,000 industrial development agencies across the country will do their part by creating more new jobs under this provision.

STATEMENT OF HERSCHEL H. FRIDAY ON BEHALF OF THE MARMON GROUP OF CHICAGO, ILL.

I am Herschel H. Friday, partner in the law firm of Friday, Eldredge and Clark, Little Rock, Arkansas. I would like to give the following presentation on behalf of The Marmon Group of Chicago, Illinois.

The Marmon Group comprises autonomously operated units that make and market consumer, automotive, industrial and building products; manufacture mining, transportation, institutional and agricultural equipment; refine, process and market metals; fabricate metal components for consumer and industrial products; mine, prepare, transport and sell coal; and perform related services. We have relied to a great extent upon industrial development revenue bond financing for our expansion needs. Since 1957 when our first expansion occurred in Jonesboro, Arkansas, the several companies within the Group have utilized this medium of financing a total of thirty-two times. Of those companies which are now in full production, a total of 2,800 jobs have been provided, present annual payroll exceeds $126,500,000, with gross annual sales of $187,000,000, all being directly attributable to industrial development revenue bond financing. In addition, the Group has had approved another $16 million in industrial development revenue bond monies for nine others.

As you may know, small issue IDBs are bonds issued by state and municipalities for the purpose of acquiring or building industrial or commercial facilities for subsequent lease or sale to private companies at a price sufficient to amortize and pay debt service on bonds. The tax exemption afforded these bonds has provided an effective incentive in the past for industrial and commercial expansion by reducing the interest cost of borrowed "seed money" and, consequently, has encouraged the creation of new jobs.

Limitations were set in 1968 of $1 million for IDBs not subject to the capital expenditure limitations and $5 million maximum capital expenditures limitation. For a number of years, we were able to build new facilities, acquire machinery and equipment and expand existing factories within these limitations. Construction and capital equipment expenditures have increased substantially, however since 1968, and we have either chosen not to expand or have delayed expansion or capitalization of facilities because capital costs have increased substantially since 1968 and it is difficult for us to utilize IDB financing because of the $5 million capital expenditure limitation.

Although we would undoubtedly have expanded our operations and increased sales over earlier years without IDB financing such expansions and increases certainly would not have been as extensive. Many of our expansions have resulted from being landlocked in a location or being an out-dated facility. With the relatively attractive financing available from IDBs we have built new factories or modernized existing ones. The alternative without such financing would have been to allow these facilities to atrophy. We have found also that once available employment has peaked in an area, we have chosen to expand by building a facility elsewhere where unemployment is high and communities are looking for industry.

It has been our experience that industrial development revenue bond financing in its present form is a proven method and permits expedient expansion. The results are consistent, financing is readily available, and with company guarantees, the risk to governmental authorities is slight.

As one example of the results of such financing, for one of our recent bond issues, a site was located, an inducement resolution was obtained from an Authority formed for that purpose, and funds were received a total of twenty-six days after the date of the inducement resolution. The new facility was constructed during the winter months in the Midwest, and went into production within four months of the resolution. That facility within three years is employing 200 people in a community which was actively seeking employment for its citizens.

We urge that interest on industrial development revenue bonds issued for pollution control and industrial parks keep their tax-exempt status. We strongly oppose the proposed limitation on use of "small issue" bonds, to "economically distressed areas". We have seen no definition of such terms and a narrow definition of "economically distressed areas" will be of little benefit regardless of the proposed increase in the ceiling on small issue bonds. Such a definition would limit their use to large urban areas only and we believe that, with our own experience in small towns and rural areas being highly successful and mutually beneficial, limitations like the ones originally proposed under the Tax Program would severly hinder companies like ourselves which rely heavily on industrial development revenue bonds.

Next let me call Mr. Jack Allen, president, Independent Petroleum Association of America.

STATEMENT OF JACK ALLEN, PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. ALLEN. Thank you very much Mr. Chairman.

We have filed our statement, and I will summarize it, if I may.

I am appearing today on behalf of the Independent Petroleum Association of America, and also on behalf of 19 unaffiliated State and regional associations which join us in the comments.

In order to place in proper perspective our comments, it is necessary to establish a few basic facts which are too frequently overlooked.

In the mid-1950's there were about 20,000 independent explorer-producers active in the United States. By 1971, 10,000 of these small businesses had merged out, sold out, or otherwise got out of business. Some of them have gone broke. The competitive viability of independent producers has suffered primarily as a result of—

(1) energy prices held artificially low by the Federal Government; and

(2) counterproductive tax policies of the Federal Government.

The CHAIRMAN. I have read your statement. Could I just take your statement, and interrogate you on it, because I want to ask you questions on some points that cause specific problems.

If we do what you are asking here with regard to the intangible drilling expenses, and with regard to the 65 percent tax income limitation on percentage depletion, I can see the possibility that this will be flagged by Treasury next year, in the report on income tax returns, and instead of 22 people paying no income tax, there would be 200 people who pay no income tax and quite a few members of your association would be in that group.

Do you really think that we ought to pass something that is going to cause the demagogues in this country to zero-in on your industry, and on everybody in the oil and gas industry, as a bunch of millionaires who pay no taxes; or do you have an alternative proposal to make, that guarantees that they do pay some reasonable amount?

Mr. ALLEN. We are not trying to get out of paying taxes. We are trying to attract capital that will keep us from losing our investors, Senator. I think the proposals we have made here will keep and enable us to attract investment capital which we sorely need. We need far more than we have been spending for the past 6 years. We need about three times as much.

The CHAIRMAN. I appreciate that, sir. But I think that those people ought to pay at least 10 percent of what they are making.

If you speak in terms of how a banker would analyze a profit and loss statement, he would look at the percentage depletion, and the intangible drilling expenses, and he would say: "After all, that money has not been wasted. It has gone into this business. I know that for the purpose of his shareholders, he is making money." He would do the same thing, and if we capitalized that, here is what the profit would be.

In other words, he would not report to his shareholders that there are no profits, therefore, they would be paying no taxes, in the same way that we would report to the Treasury. What I am saying is, do you think that we ought to fix this thing up so your members, instead of paying nothing or having the Government owing them money, they will be paying something.

I think that they ought to pay 10 or 15 percent of what their economic income is in taxes.

Mr. ALLEN. I think they would. I don't think that you can get out of taxation altogether. We are not suggesting that, or seeking that. We are trying to get it where we can attract capital that we are going to need.

The CHAIRMAN. I have never seen an oil man who would not go after oil or gas just because he had to pay a 10 or 15 percent effective tax rate.

While I have been regarded as a spokesman for your industry, from time to time, especially by those that do not like you, I would be the first to say, and I was once in the business myself—that is where most of my income comes from, oil and gas. It seems to me that we ought to see to it that everybody who is making substantial income in that business is paying out at least some reasonable amount of taxes, to protect the image of the industry itself, otherwise you will be in for some bad time.

Mr. ALLEN. We don't quarrel with that, Senator. That is not the thrust of what we are trying to get over today. We are really trying to say that we have to have some encouragement in the form of capital necessary to conduct the increased drilling over the next 10 years that is going to be necessary for us to make a dent in the domestic supply problem.

The CHAIRMAN. I want to help you, but I want you to make it easy for me. Let me make this suggestion. Have your people get a copy of this "High Income Tax Returns—1975 and 1976," and study this chart where it shows what percentage of the people pay less than 5 percent of their income in taxes, and what percentage paid less than 10 percent, and so on.

Get your people to study that, to help us put together a program that will help meet your problem, and also will insure that the demagogues, who would say: "You made a lot of money, and you paid no taxes," cannot defeat those amendments.

Mr. ALLEN. We will be glad to study it, and make all the comments we can. It is not limited to people in the oil industry, and I think that there are very few people, very few.

The CHAIRMAN. We had 22 nontaxpayers, and I don't think that any of them were in the oil and gas business as far as I know, but they may be.

Mr. Reginald Jones, who testified for the Business Roundtable talked to me personally before he took the witness stand up here, that while testifying for what he thought was the right tax reduction as far as the big business is concerned, he would be the first to insist that we ought to have a minimum tax to assure that no wealthy person got by without paying a reasonable amount of taxes. There is a man who knows all about the tax laws, and he paid a substantial income tax. He likes to josh me, and points out that he paid more than I did. But I am not embarrassed to say that from my own point of view, I am paying a lot of taxes.

I think that we ought to try to see to it that while we provide all of these incentives, we are not going to be looked upon by some people, who have given the public a bad time about it, as getting by without paying a fair share. I would hope that you would help me bring that about.

Mr. ALLEN. We will. It is not our position, nor that of any of the associations with which I am familiar, to escape taxation. We are looking at what we can do to provide some capital to help solve this problem. That is the thrust of our recommendations today.

Particularlly, I would like to call your attention to the need to change the intangible drilling expense for this year on a current basis. We need that very badly, the independent producers, because we are losing investors every day, and we are having to cancel projects this year, and there is uncertainty next year. We need to solve that situation, and it looks like the energy bill has us hostage, and we need to get it in the tax reform bill in 1978.

The CHAIRMAN. It looks like the picture for the industry is improving. One of these days, I might go back in the business. At one time, I was in it, and then the situation got so bad that my family thought that it was best to get out of it.

It looks like with the price being what it is, and if you can find some new oil, maybe one of these days, we will be able to make a decent profit. For the independent producers in Shreveport, La., things are looking up a little bit. The price of new oil, if they can find it, seems to be enough to justify taking a chance. Is that the impression that you have gained around other areas?

Mr. ALLEN. The price has encouraged people to buy back into it. The taxation on IDC has discouraged people from making the investment. That is what we are trying to address ourselves to. Today, it is the independent producers who are hurt by this policy. We would hope, if we could, to get some relief on the tax we pay on the intangibles.

The CHAIRMAN. This has been worked out between the House and Senate already. I think that this is going to happen. To coin a phrase, I think you can depend on that. As for the rest of it, we will see what we can do. We will try to help you, and we would like to.

Let me apologize at this point for the absence of my colleagues They are out voting. I am missing a vote to be with you.

[The prepared statement of Mr. Allen follows:]

STATEMENT OF JACK M. ALLEN, PRESIDENT FOR INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

And on behalf of—
California Independent Producers Association.
Kansas Independent Oil and Gas Association.
Kentucky Oil and Gas Association.
Liason Committee of Cooperating Oil and Gas Associations.
Louisiana Association of Independent Producers and Royalty Owners.
Michigan Oil and Gas Association.
North Texas Oil and Gas Association.
Oklahoma Independent Petroleum Association.
Pennsyllvania Oil, Gas and Minerals Association.
Permian Basin Petroleum Association.
National Stripper Well Association.
Illinois Oil and Gas Association.
Texas Independent Producers and Royalty Owners Association.
West Central Texas Oil and Gas Association.
Ohio Oil and Gas Association.
Independent Petroleum Association of Mountain States.
Panhandle Producers and Royalty Owners Association.
The Land and Royalty Owners of Louisiana.
Pennsylvania Grade Crude Oil Association.

I am Jack M. Allen of Perryton, Texas, an independent oil and gas operator currently serving as President of the Independent Petroleum Association of America (IPAA). The IPAA is a national organization of some 5,100 members whose basic interest is in the exploration, development and production of crude oil and natural gas in all producing areas of the United States. Most of our members are independent operators who own their businesses personally. Some are publicly-owned independents.

We are joined in these comments by the nineteen unaffiliated state and regional oil and gas associations listed in the cover page. The combined membership of these associations includes virtually all of the 10,000 to 12,000 independent oil and gas producers in the United States.

In order to place in proper perspective our comments about the pending tax proposals, it is necessary to establish a few basic facts which are all too frequently overlooked.

In the mid-1950's there were about 20,000 independent explorer-producers active in the United States. By 1971 at least half of these—10,000 independent small businessmen—had merged out, sold out or gone broke. The competitive viability of independent producers has suffered primarily as a result of:

(1) Energy prices held artificially low by the federal government; and

(2) Counterproductive tax policies of the federal government.

While our domestic petroleum resources are enormous, the capital needed by the industry to exploit these resources is equally large. All recent studies agree on that point. A study by the Bankers Trust Company indicates that the entire energy industry now accounts for about one-fifth of the capital market. In the fifteen years between 1975 and 1990, Bankers Trust estimates that under a business-as-usual scenario the pertoleum industry alone will need $300 billion in new capital. These findings are similar to those of the Chase Manhattan Bank. They have estimated that the petroleum industry will have to spend about $265 billion in the decade from 1976 through 1985. (See attached chart titled "Expenditures vs. Exploration and Development").

All authoritative studies, although they vary in magnitude, point in one direction. All indicate that we must immediately take those tax and pricing actions necessary to generate the needed capital. Otherwise, this nation will continue to grow increasingly dependent on insecure and high-cost supplies of foreign energy. Unfortunately, the provisions of the Revenue Act of 1978 surely would not help; they would not provide the needed exploration and development incentives, nor would they help the industry generate the substantial sums of necessary capital.

It is clear that in order to reduce or eliminate our unhealthy dependence on foreign energy supplies, a favorable economic environment for investment in the domestic petroleum industry must be provided.

The purpose of our presentation is to suggest changes to the Revenue Act of 1978 which are essential if domestic independent producers are to have an opportunity to help meet the future needs of consumers for petroleum fuels. The failure of this legislation to include the incentives needed to generate the necessary investment capital for domestic petroleum exploration and development activities will, in our view, limit the activities of independent producers and assure declining domestic production and chronic shortages in the near future.

Let's look for a moment at where we stand. During the first six months of 1978, the United States consumed about three and one-half billion barrels of petroleum products, of which about 42 percent came from high-cost, insecure foreign sources. Just thirteen years ago the United States had the ability to produce more oil and gas than we consumed. The United States produces less petroleum now than we did before the Arab petroleum embargo; and we are now more dependent on the embargo participants for our petroleum imports than we were before the embargo.

Domestic oil and natural gas constitute the cheapest energy source for United States consumers. The composite price of domestic oil and natural gas (converted to barrels of crude equivalent) is less than $6.50 per barrel. We now pay about $15 per barrel for imported oil. Synthetic gas is currently available at some $18 or more per equivalent barrel. Imported LNG from unreliable foreign sources is available at prices in the order of magnitude of $25 per equivalent barrel.

Why not unleash this potential of less costly domestic energy to the maximum extent possible by:

(1) Providing tax incentives that will encourage capital formation; and

(2) Removing the burdensome price controls on natural gas and oil so that producers may devote their energies to exploration and development rather than in regulatory red tape.

There appears to be no disagreement about the need for incentives to develop alternatives to conventional oil and natural gas supplies. What does seem to be overlooked is that at least for the next several decades oil and gas will continue to be our primary energy sources.

Crude oil and natural gas presently supply some 75 percent of our energy. For the next several years, we will become increasingly more dependent on insecure foreign oil unless we have a vigorous, healthy and expanding domestic petroleum industry. Instead of being encouraged by sound, consistent federal tax and pricing policies, oil and gas producers have been confronted with the following:

(1) 1954 to the present—continued price controls on natural gas keeping prices artificially low;

(2) October 9, 1969—percentage depletion cut from 27½ percent to 22 percent;

(3) April 30, 1974—General price controls terminated, but continued on crude oil and natural gas;

(4) ~~March~~ 29, 1975—enactment by Congress of Tax Reduction Act of 1975, substantially repealing percentage depletion for about 85 percent of domestic oil and gas. This longstanding tax policy has been left intact for some 100 other extractive industries;

(5) February 1, 1976—rollback of approximately $1.50 per barrel for new crude oil;

(6) September 16, 1976—enactment by Congress of Tax Reform Act of 1976, retroactively imposing punitive tax on cash expenditures (IDC)—not on income of independent oil and gas producers;

(7) July 1, 1976—imposition of a price freeze on all domestic crude oil;

(8) December 31, 1976—a rollback of 20 cents per barrel for new domestic crude oil and continuation of existing price freeze on crude oil;

(9) February 1, 1977—a retroactive doubling of rental fees on most oil and gas leases on federal onshore lands;

(10) March 1, 1977—a rollback in United States crude oil prices of 45 cents per barrel on new oil;

(11) April 27, 1977—Issuance of Revenue Ruling 77-176, reversing policy followed by producers and the IRS for over 30 years concerning treatment of "farmout well" transaction;

(12) August 1, 1977—Continuation of freeze on crude oil prices;

(13) September 1, 1977—Resumption of crude oil price increases but at levels less than permitted by law and less than previously promised by government spokesmen;

(14) Through June 1978 producers have been denied about $2.3 billion in revenues that they ought to receive under existing crude oil price control statutes.

The combined impact of these actions on domestic oil and gas producers is to remove many billions of dollars which otherwise would be available for additional exploration and drilling. This abbreviated listing should dispel any doubt as to why our domestic oil and gas production is declining and why we grow ever more dependent on insecure foreign oil. The 10,000 independent producers and explorers who drill most of the wells should be making a maximum effort in developing new supplies. But they cannot because of the counterproductive effect of adverse government tax and pricing policies.

Professional geologists nationwide agree that vast quantities of natural gas and crude oil remain to be produced in this country. In 1967, the National Petroleum Council, at the request of the Department of Interior, began a study of future petroleum provinces of the United States. The results of the coordinated study, in which dozens of the nation's most prominent geologists participated, was published in two volumes in 1971. Over 3,000,000 square miles of basinal area in the United States were identified as having sediments prospective for oil and gas. This compares with only 50,000 square miles of which oil and gas production exists, or has existed to date—less than 2 percent of the prospective area, and most of that is relatively shallow. With the nation being called on to attack our energy shortages with the "moral equivalent of war," it seems highly inconsistent that we should also be told to turn our backs on 98 percent of the prospective oil and gas sediments.

The 1975 United States Geological Survey study is consistent with the majority of other resource base studies and is considered realistic by many. The U.S.G.S. estimate of potential conventional natural gas and oil resources are shown in the attached chart "U.S. Petroleum Resource Base." The proved and potential gas supplies in this evaluation amount to a 55-year supply at the 1976 production rate. Another ten years' potential exists in "currently sub-economic" resources that U.S.G.S. believes will become available with improved technology and/or economics.

These estimates do not include potential natural gas volumes from tight shales and sands in both the Western and Eastern United States, geopressurized reservoirs on the Texas-Louisiana Gulf Coast, or in sediments below water depths of 600 feet. Obviously, development of techniques which would bring these tremendous potentials into production would extend our access to natural gas not by just decades, but by more than a century.

IPAA firmly believes that the solution to our dependence on foreign crude oil is to unleash private enterprise. The United States has the potential petroleum resources; and with the proper economic environment, the petroleum industry can produce the needed petroleum supplies.

While alternative sources of energy will be able to assume a greater share of our energy burden in the years to come, crude oil and natural gas will continue to provide the bulk of our energy requirement. The only real question remaining is whether crude oil and natural gas will be developed from our domestic resource base or whether we will allow ourselves to become increasingly dependent on foreign nations for our energy lifeblood. The attendant balance of payment problems and the precarious national security situation make it clear that U.S. consumers should rely on U.S. producers, not foreign countries, for their energy supplies.

Recognizing that the alternative to domestically produced energy is imported energy, it becomes evident that it is economically efficient and prudent to encourage the full development of our oil and gas resources. IPAA believes that the Congress must provide a sound and reliable oil and gas taxation policy which encourages capital formation and spending by the domestic petroleum industry. The Congress must correct past taxation policies which are now inhibiting expenditures. Specifically Congress should:

(1) Eliminate for independent producers intangible drilling expenses as a tax preference item subject to the minimum tax. Such a tax is not a tax on income, but instead is a tax on expenditures.

(2) Repeal the 65 percent of taxable income limitations on percentage depletion for independent producers of crude oil and natural gas. This provision discourages independent producers from maximizing their drilling expenditures.

(3) Halt the previously enacted phase-down in the percentage depletion rate and allowable volume. This would materially assist independent producers to retain investment capital.

(4) Provide for expensing of geological and geophysical expenses rather than requiring their capitalization.

(5) Enact an Energy Development Investment Tax Credit which would allow a direct credit against federal income tax for expenditures which result in greater domestic energy supplies.

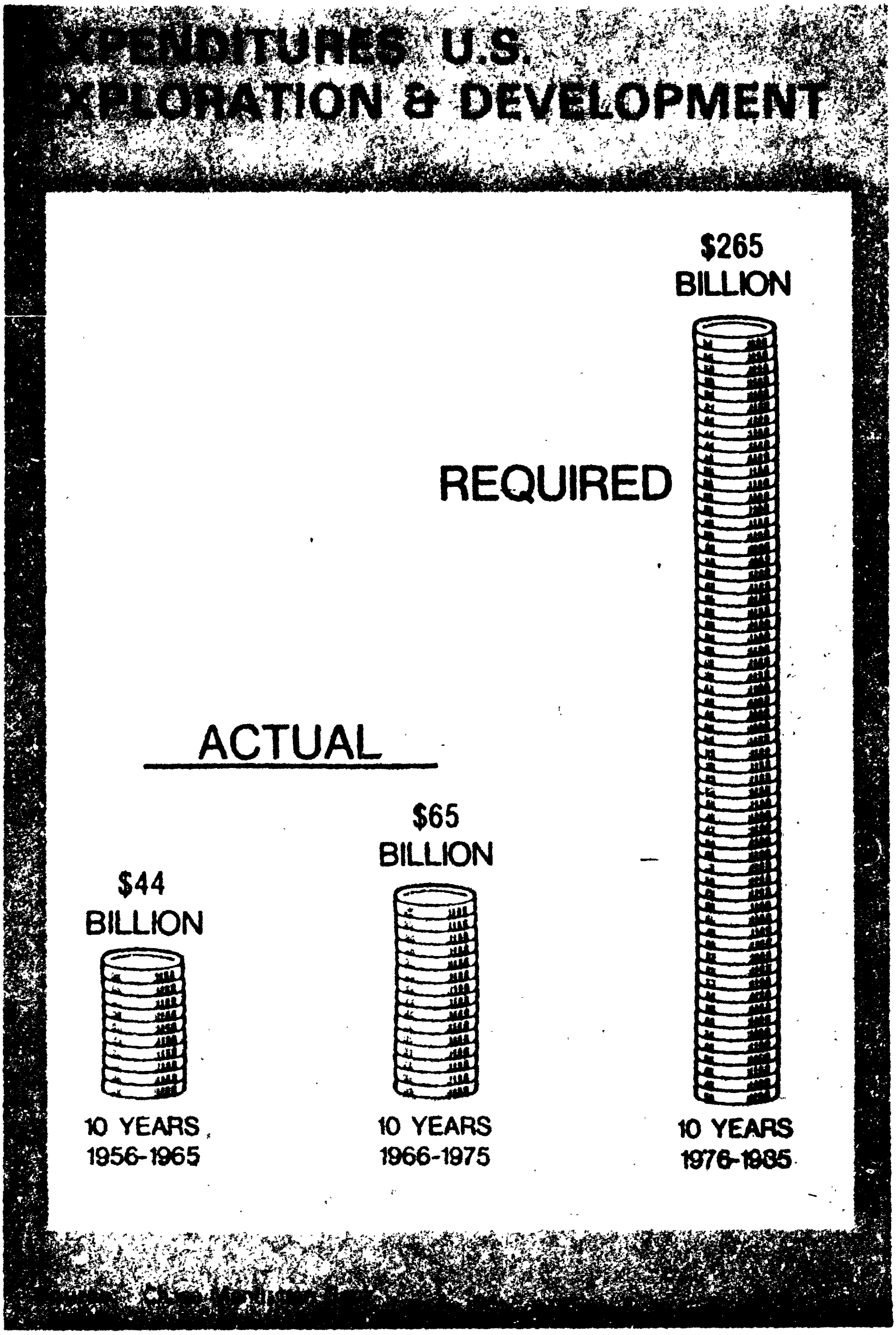
In conclusion I would like to emphasize the urgent need to include in the Revenue Act of 1978 a provision to eliminate IDC (intangible drilling expenses) as a tax preference item.

We are now in the eighth month of the year, but, independent producers and their investors do not yet know whether or not intangible drilling expenses will be subject to the minimum tax. This is creating great uncertainty. It is delaying and frustrating exploratory and development activity.

Since this corrective action has already been passed by both the House and the Senate as a part of the Energy Program, it is urged that it be incorporated in the pending bill.

We have the natural resources, knowledge and capacity to solve our energy problem. What we lack are adequate incentives which the market place will provide if unreasonable government interference is removed. We therefore respectfully request that positive incentives such as suggested herein be included in this legislation.

Thank you Mr. Chairman.


EXPENDITURES U.S.
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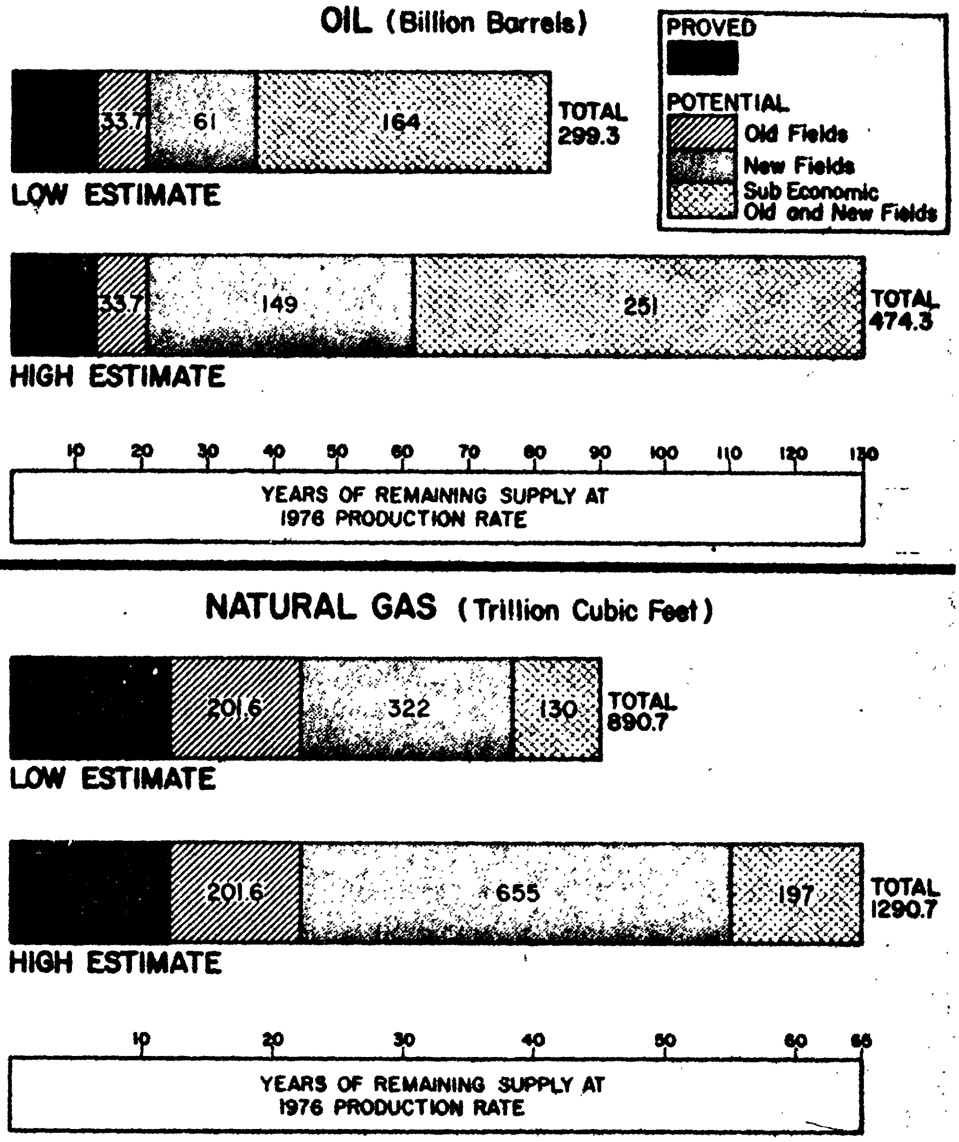
U. S. PETROLEUM RESOURCE BASE



SOURCE: U.S. Geological Survey (1976). These USGS estimates do not include potentially large supplies in tight sands, shales, or geopressured reservoirs or from water depths greater than 660 feet.

The CHAIRMAN. We will have a recess at this point, and we will come back at 1 o'clock.

[Whereupon, a short recess was taken.]

The CHAIRMAN. The committee will come to order.

Next we will hear from Mr. Jerry C. Connors, director, legislative affairs, American Automobile Association.

Mr. ARCHER. Mr. Chairman, I am John Archer, the assistant director of legislative affairs. Unfortunately, Jerry Connors could not make it today.

The CHAIRMAN. Very well.

STATEMENT OF JOHN ARCHER, ASSISTANT DIRECTOR OF LEGISLATIVE AFFAIRS, AMERICAN AUTOMOBILE ASSOCIATION

Mr. ARCHER. AAA is pleased to have the opportunity to testify today on H.R. 13511, and thereby represent almost 20 million members, as well as motorists generally. Specifically, we are dismayed by section 111 of H.R. 13511, which would repeal the Federal income tax deduction for State and local taxes imposed on gasoline, diesel and other motor fuels not used in business or investment activities.

As you are aware, the full House of Representatives never had the opportunity to vote on the merits of the repeal of the gas tax deduction since the rule granted the tax bill did not permit an amendment to strike section 111. The same procedure was used when the House passed its version of the Carter Energy package. A provision repealing the gas tax deduction was included by the Ways and Means Committee, but the full House was not permitted to vote on the issue because of a restrictive rule.

AAA does not imply any criticism of the House leadership by mentioning the lack of floor votes on the gas tax deduction. The size of the House membership and the complexities of tax and energy legislation probably precluded open rules on those two pieces of legislation. Rather, we mention the point solely to emphasize that passage of those two bills does not imply full House endorsement of repeal of the gas tax deduction.

Fortunately, the full Senate did consider the issue last year. After your committee resisted attempts to include a provision repealing the gas tax deduction in the Senate version of the energy bill, the Senate voted overwhelmingly, 65 to 12, to retain the deduction when the issue arose on the Senate floor. AAA strongly urges committee members to continue to reflect the full Senate's support for the gas tax deduction.

As the Ways and Means Committee Report on H.R. 13511 acknowledges, practically everyone who itemizes utilizes the gas tax deduction. It is one of the few deductions in the tax code that is designed for and easily understood by the common man. If he uses the tax table, and practically everyone does, he needs only his mileage figures for the year to determine the amount of his deduction.

So it is not one of those deductions which if eliminated would simplify our excessively complex tax code. But if it is eliminated, the average American will not have any trouble understanding the impact on him. He will just do a slow, quiet burn if he reads that Congress has eliminated one of the few tax deductions designed for him.

Much has been said about the fact that this year's tax bill benefits the middle- and upper-income taxpayer. To some extent that is true. But we would like to stress that even with this year's tax cut, most middle income people who do not benefit from reduced capital gains taxation will still be worse off next year because of inflation and much higher social security taxes.

They are the people who need the deduction. Their numbers are not small. Anyone financing the purchase of a home will generally continue to itemize deductions and, therefore, will benefit from gasoline tax deduction. For 1976, the last year for which accurate figures are available, almost 26 million people itemized, approximately 30 percent of all taxpayers.

The increase in taxation that these taxpayers would experience if the deduction is eliminated is greater than is initially apparent. Besides the estimated increase in Federal revenues, State and local taxation would also increase in most States because of a ripple effect built into the tax system.

Thirty-three States and the District of Columbia pattern their income tax return after the Federal return so as to permit the Federal gas tax deduction to be counted as a State deduction as well. Many county and municipal governments do likewise. If the Federal tax deduction is eliminated, those State and local deductions will also be eliminated.

The burden created by the deduction's elimination would be borne most by those who must use their automobiles for transportation to and from work, particularly rural residents who must drive long distances for all necessities of life, since they have no alternate means of transportation.

We also strongly believe that there is no connection between the tax deduction and our energy problem. A virtual doubling of the cost of gasoline over the past 5 years caused by skyrocketing oil prices has not noticeably altered U.S. gasoline consumption because the demand for gasoline is inelastic.

Most Americans work for a living, with the vast majority not having access to alternate means of transportation. If enormous increases in the price of gasoline will not deter driving, elimination of a mere tax deduction will have no impact at all.

We are also concerned by suggestions that the gas tax deduction should be eliminated because it permits tax cheating. We believe this is a false issue. All tax deductions are subject to some abuse, and the gas tax is no different. But this is certainly not a good reason to eliminate a valid deduction.

Penalizing tens of millions of honest, over-taxed motorists in order to curb possible abuse by a few is simply unfair.

This concludes my remarks, and I will be happy to answer any questions.

The CHAIRMAN. Thank you very much. I think that you have made a very good statement. We appreciate it.

[The attachment to Mr. Archer's statement follows:]

ATTACHMENT

STATES AFFECTED BY THE "RIPPLE" EFFECT

States patterning their income tax returns on the Federal form in such a manner as to permit the Federal gas tax deduction to be counted as a State deduction as well: (Source—National Association of Tax Administrators.)

Alabama	Kansas	North Dakota
Alaska	Kentucky	Oklahoma
Arizona	Louisiana	Oregon
Arkansas	Maine	Rhode Island
California	Maryland	South Carolina
Colorado	Minnesota	Utah
Delaware	Missouri	Vermont
District of Columbia	Montana	Virginia
Georgia	Nebraska	West Virginia
Hawaii	New Jersey	Wisconsin
Idaho	New Mexico	
Iowa	New York	

The CHAIRMAN. Next we will call on Mr. Kent M. Klineman, Klineman Associates, accompanied by Mr. Edward Merrigan.

STATEMENT OF KENT M. KLINEMAN, KLINEMAN ASSOCIATES, ACCOMPANIED BY EDWARD MERRIGAN

Mr. KLINEMAN. Thank you, Mr. Chairman, for the opportunity to appear before you today. My name is Kent M. Klineman. My firm, Klineman Associates, is located at 1345 Avenue of the Americas in New York City. We are a small business concern, like hundreds of others located throughout the United States. We are engaged in the leasing of equipment to business and professional firms.

I am accompanied by my counsel, Edward L. Merrigan of Washington, D.C.

The purpose of our appearance, Mr. Chairman, is to urge your committee to correct an extremely serious tax inequity which was originally created, unintentionally, we believe, for small business equipment leasing firms throughout the United States, by the so-called "at risk" provision of the Tax Reform Act of 1976, an inequity that will be unnecessarily magnified if Congress enacts title II of H.R. 13511 in the form pased by the House of Representatives.

In my opinion, unless the Senate acts now to eliminate this glaring tax inequity, it will soon destroy small equipment leasing firms throughout the country which simply cannot continue to finance all their lease transactions on a total "at risk" basis in order to meet the requirements of the Tax Reform Act of 1976 and title II of H.R. 13511, as passed by the House.

The CHAIRMAN. Mr. Klineman, if I may, let me ask that your statement be entered in the record, and I want to talk to you about your problem.

Mr. KLINEMAN. Yes.

The CHAIRMAN. If Mr. Merrigan is able to spend as much time explaining this problem to other Senators as he has with me, I have no doubt that you will win, because he has explained to me, not one time, but about six times, to the extent that I am not 100 percent sure you are right about this matter, I am 1,000 percent sure that you are right about this matter.

What you people are going to have to do is to somehow get the attention of at least 50 other Senators long enough to be sure that they understand your problem. There are other business people who have a parallel problem, don't they?

Mr. KLINEMAN. A large number of them.

The CHAIRMAN. I will ask every Senator that you want to talk to, to talk to you. If you cannot stay here in town, I will ask them to talk to Mr. Merrigan. You also ought to get your people out and hustling. Get the fellow from Nebraska to call Mr. Curtis, and talk to him personally; and I will ask Mr. Curtis to talk to Mr. Merrigan.

Then you can have the fellow from Texas talk to Mr. Bentsen. If he can't talk to Mr. Bentsen, then I will ask Mr. Bentsen to talk to Mr. Merrigan. So it goes. Don't make the mistake of thinking that you have prevailed because you have a committed chairman and a ranking member on your side. We each have only one vote.

You have to get to the troops. You have to talk to these people. You may have to talk to 100 of them. It will just require a little bit of work. As soon as you can get on the telephone and talk to these fellows, get them to grab their Senator. They don't have to come to Washington to go and explain this to them, because the Senators are going to be home during the recess. They can sit down with them and be sure that they understand it.

I have no doubt that you will win on this matter, because you have a good case.

Mr. MERRIGAN. Thank you very much. The reason that we came to testify about it again is that, you know, in H.R. 13511, the at-risk position is to be increased again. There is a provision in there that would extend it to all small business operations. So while you are attempting to correct the mistake of 1976, the Treasury Department is trying to broaden it to all small businesses, while exempting the big corporations. So we felt compelled to be here again.

Mr. KLINEMAN. In 1976, your committee in its report specified that you did not want to include corporate lessors. It was only supposed to apply to individual lessors and tax shelters. But now the House version of the bill extends to closely held corporations for reasons that we cannot imagine.

The CHAIRMAN. Senator Haskell, who was the leader in doing something about the at-risk issue is not here today, but he is a candidate for office. I know that he has done a lot for small business, and he wants to do more for small business. You will have to get your small businessman from Colorado to talk to Senator Haskell, and see what he can do.

Then, I will ask Senator Haskell to talk to Mr. Merrigan, or to both of you, and if you people can explain it to him so that he understands, I am sure that he will help you with it. He will not just be tolerant of your situation, but he will be on your side.

Let me urge you not to ignore the grassroots effects, because Senator Hansen used to say to me, when I came up here: "Young man—he is about a year older than I am—what you have to keep in mind is that what a Senator is interested in. He is interested in two things. First, his election; second, his reelection."

If these people can see that somebody back home is concerned about this matter, that is very impressive to them. In all fairness and justice, you cannot persuade the guy, if he is not here. I will ask them to read this record, but you are going to have to talk to Senator Haskell.

Mr. KLINEMAN. The unfortunate thing, Senator Long, is that sometimes these provisions creep into these bills, and the small guy is not aware of it. He becomes aware of it when his accountant tells him how much he owes in taxes and how much of an effect on his balance sheet this provision is going to have. They will wake up to it after the fact, then the screaming and yelling starts, and you have to go ahead and start considering what it is that you did.

I am not saying that we disagree about contacting the Senators. We are going to do it, and we have been doing it. Unfortunately, I think that the small businessmen, who are trying to survive, do not realize the burden that is going to be placed on them by this piece of legislation, I think, unfairly.

The CHAIRMAN. Are you represented? Do you have an association now?

Mr. KLINEMAN. I am here to represent myself. There is an association, and we have contacted them. They are slow moving. Some people seem to be faster than others.

Mr. MERRIGAN. Mr. Chairman, I think that you are perfectly right, and we need to enlist the help of other Senators. We believe that an amendment will be offered during the proceedings, on markup, by at least two other Senators. We intend to talk to the whole committee, and ultimately we hope to talk to all 100 Members of the Senate. If our case is just, we will win. If it is not just, then we will lose.

The CHAIRMAN. You can be assured that you have one vote. You have my vote. If Mr. Merrigan had spent one-sixth of the time explaining your problem to me, which would have been adequate to persuade me, if he had taken the other five-sixths of the time and talked to other Senators, you would have six votes right now, because you have a good case, but you have to talk to the troops. The chairman of the committee cannot do it for you, not without the troops.

Thank you very much, Mr. Klineman and Mr. Merrigan.

[The prepared statement of Mr. Klineman follows:]

STATEMENT OF KENT M. KLINEMAN

SUMMARY

1. *Purpose of Appearance.*—To urge the Committee, without further devastating delay, to correct an extremely serious tax inequity created for small business equipment leasing firms throughout the United States (that must compete daily with some of the largest corporations in the United States) by the "At Risk" provisions of the Tax Reform Act of 1976—a crushing inequity which will be magnified beyond belief if the Senate enacts Title II of H.R. 13511 without modification insofar as operations in the national equipment leasing industry are concerned.

2. *Competitive Conditions in the Equipment Leasing Industry Prior to the 1976 Act.*—Before enactment of the new "At Risk" provisions of the 1976 Act, big business office equipment lessors (such as IBM, Xerox, major U.S. banks and insurance companies) and local small business office equipment lessors competed on an equal footing, at least insofar as the Internal Revenue Code was concerned. Both were entitled to claim the same business tax deductions in their equipment leasing operations irrespective of how the leased equipment was purchased or financed—and usually, neither the big corporations nor the competing small business lessors had to be "at risk" on loans made to finance purchases of leased equipment since normally the equipment itself or the lease, or both, constituted sufficient security for loans.

3. *How the 1976 Act Destroyed Competitive Tax Equality in the Industry, and How Title II of H.R. 13511 Will Complete the Destructive Process.*—The Tax Reform Act of 1976 changed the tax rules for unincorporated small business equipment lessors only (firms operated by individuals, partnerships or Subchapter S corporations), while it exempted the incorporated giants of the industry from the new "at risk" requirements.

Since 1976, therefore, those small business lessors have had to be "at risk" on their regular everyday equipment leasings transactions in order to continue to claim normal equipment leasing business expenses and losses as tax deductions.

This has unfairly required small business lessors throughout the country to incur high credit risks and obligations solely for tax purposes which were otherwise completely unnecessary, and over a period of time, it will leverage these small business concerns with so much credit risk they will be unable to obtain working capital loans and other normal extensions of credit vital to their ability to continue to operate. And, as stated above, they have been forced into this "at risk" position while the 1976 Act completely exempts their big business corporate competitors.

Now, Title II of H.R. 13511 threatens to complete the destructive process by proposing inexplicably—

(i) to extend "at risk" to all other small business corporations (closely-held corporations), and

(ii) to recapture small business losses for tax purposes when the small business taxpayer's "at risk amount" is "less than zero."

4. *Violence to Antitrust Laws and Small Business Statutes.*—This entire, one-sided "at risk" concept, insofar as it applies to the equipment leasing industry, does violence to the basic objectives of the Antitrust laws and the body of Small Business legislation enacted over the years to protect small business concerns. Why should Congress continue to pass tax laws that impair the ability of small business concerns engaged in perfectly normal, lawful operations to compete with huge corporations and banks engaged in precisely the same business operations for the same business purposes?

5. *From the Very Outset, Congress Intended to Apply "At Risk" to Tax Shelter Operations Only—Not to Regular Small Business Leasing Operations.*—In 1976, Congress exempted "corporations" from "at risk" because it wanted to exempt all regular everyday equipment leasing operations from that tax concept intended for unusual extraordinary "tax shelter" operations only. But, by exempting big corporations only, Congress has greviously erred. The exemption plainly must be extended also to all competing small business entities which regularly compete with the big corporations for a fair share of the equipment leasing market.

6. *The Available Legislative Solutions.*—

(A) The expanded "at risk" provisions of Title II of H.R. 13511 must be rejected entirely insofar as the equipment leasing industry is concerned, and this Committee must adopt an amendment to Title II, such as the Johnston amendment, which will exempt small business concerns regularly engaged in equipment leasing from "at risk," on the same basis as big corporations are presently exempt.

(B) In the alternative, the Committee should consider adoption of a Limitation On Artificial Loss (LAL) approach to equipment leasing transactions in lieu of "at risk"—an approach which would (1) tax artificial equipment leasing shelters while (2) it allows the regular equipment leasing industry to operate fairly, equitably and competitively insofar as the Internal Revenue Code is concerned.

STATEMENT

Mr. Chairman, my name is Kent M. Klineman. My firm, Klineman Associates, located at 1345 Avenue of the Americas in New York City, is a small business concern, and like hundreds of others located throughout the United States, it engages in the leasing of office furnishings, machines and equipment to business and professional firms which prefer to lease rather than buy their office requirements. I am accompanied by counsel, Mr. Edward L. Merrigan of Washington, D.C.

The purpose of our appearance, Mr. Chairman, is to urge the Committee to correct, without further devastating delay, an extremely serious tax inequity originally created, unintentionally we believe, for small business equipment leasing firms throughout the United States (that must compete day in and day out with some of the largest corporations in the nation) by the so-called "At Risk" provisions of the Tax Reform Act of 1976—a crushing inequity which will be unfairly and unnecessarily magnified beyond belief if Congress enacts Title II of H.R. 13511 in the form it was passed by the House of Representatives.

In my opinion, unless the Senate acts now to eliminate this glaring tax equity, it will soon destroy small equipment leasing firms throughout the country which simply cannot continue to finance all their lease transactions on a total "at risk" basis in order to meet the requirements of the Tax Reform Act of 1976 and Title II of H.R. 13511, as passed by the House.

Prior to enactment of the new "at risk" provisions of the 1976 Act, big business office equipment lessors (such as IBM, Xerox, major U.S. banks and insurance companies) and local small business office equipment lessors competed on an equal footing, at least insofar as the Internal Revenue Code was concerned. Both were entitled to claim, on the same basis, expenses, depreciation and losses on office equipment they owned and leased to their customers, irrespective of how the equipment was purchased or financed—and usually, neither the big corporation nor the competing small business lessors had to be "at risk" on loans made to finance purchases of leased equipment since normally the equipment itself or the lease, or both, constituted sufficient security for loans.

The 1976 Act, however, unintentionally and unfairly changed the tax rules for unincorporated small business equipment lessors only, while it left the incorporated giants of the equipment leasing industry free to continue to operate precisely as they did in the past. It did this by inadvertently subjecting small equipment leasing concerns (individuals, partnerships and Subchapter S corporations) to the oppressive new "at risk" tax rules of Section 465, while it expressly exempted their large incorporated competitors from those "at risk" requirements.

As a consequence, since 1976, many small business concerns have had to be "at risk" on their regular everyday equipment leasing transactions solely in order to be able to continue to claim normal business deductions for tax purposes, while competing large corporate lessors have been entirely exempt. This has unfairly required small business lessors throughout the country to incur credit risks in connection with equipment leasing transactions solely for tax purposes which were otherwise completely unnecessary, and over a period of time, it will leverage these small business concerns with so much credit risk that they will be unable to obtain working capital loans and other extensions of credit vital to their ability to continue to operate. And, as stated above, they have been forced into this position solely by new "at risk" tax rules from which their big business competitors are totally exempt.

Now, Title II of H.R. 13511 proposes to extend "at risk" even further to small business equipment leasing while the big corporations will continue to be wholly exempt. In this rgeard, Title II, as passed by the House, seeks vaguely and inexplicably—

(i) to extend "at risk" to all activities other than real estate;

(ii) to extend "at risk" to all closely-held corporations (5 or less stockholders); and

(iii) to recapture small business "losses" for tax purposes when the amount "at risk" becomes "less than zero."

Plainly, there can be no justification whatsoever, under the tax laws or otherwise, for the imposition of oppressive "at risk" requirements on small business equipment lessors, while their big corporate competitors are exempt. And even worse, there can be no justification for H.R. 13511's proposed extension of "at risk" to "closely-held corporations" when all other larger corporations are exempt. This entire concept is diametrically opposed to the objectives of the Antitrust Laws of the United States, and to all the small business legislation Congress has adopted over the years to preserve and protect small businesses. Why should Congress now knowingly wish to impair the ability of small business concerns engaged in perfectly normal, lawful business operations to compete with huge corporations, banks and insurance companies engaged in precisely the same business operations and for precisely the same business purposes?

Congress' sole goal from the very outset has been to impose "at risk" on tax shelters only—and from the very beginning, Congress made it clear that regular everyday equipment leasing operations should be exempt from "at risk." That explains why Congress exempted "corporations" from "at risk" in the first place. It wanted to exempt everyday equipment leasing operations such as those of Hertz, Avis, National Car Rental and their small business competitors in the automobile leasing industry; and those of Xerox, IBM, the major banks and their small business competitors in the office equipment leasing industry from these oppressive new tax rules intended for artificially-created "tax shelters" only.

In this regard, both the Senate and House reports in support of the 1976 Act went to great lengths to explain that the new "at risk" rules are aimed strictly at tax shelters which allow taxpayers to offset "artificial losses" from outside investment activities such as those involving farming, motion picture production and very large, unusual equipment leasing transactions against income received from unrelated businesses or professions—and that under no circmustances were the "at risk" rules meant to apply to regular equipment leasing activities such as those conducted by large and small companies in the automobile and office equipment leasing industries (see House Report 94-658, p. 25; Senate Report 94-938, p. 39).

Indeed, the Senate Report emphasized that application of "at risk" to normal, everyday business operations in these particular industries would be counterproductive and would eliminate many such operations—a serious mistake in time of high unemployment (Senate Report 94-938, p. 39).

But, by exempting corporations only in the 1976 Act, Congress patently erred. It apparently assumed all regular, normal equipment leasing concerns are incorporated. The big companies and the banks are incorporated, but many of their local small business competitors are not. Now, Title II of H.R. 13511 seeks to compound the error of the 1976 Act by restricting the exemption exclusively to "big corporations," while specifically making all "small corporations" (Subchapter S and closely-held corporations) subject to "at risk."

Further evidence that Congress never intended any such ridiculous result is also found in the reports in support of the Tax Reform Act of 1976. In the Senate Report, for example, the Finance Committee specifically described the type of tax shelter equipment leasing activities to which the new "at risk" rules were intended to apply. The activities listed are extraordinary, multimillion-dollar artificial leasing operations involving the leasing of aircraft, ships, railroad rolling stock, oil drilling rigs, and nuclear fuel assemblies. No indication of any kind is given that this Committee or the Senate intended to apply "at risk" to the normal leasing activities of small business concerns regularly engaged in business in the equipment leasing industry.

CONCLUSION

1. The expanded "at risk" provisions of Title II of H.R. 13511 should be rejected entirely insofar as equipment leasing is concerned. If big corporations in the equipment leasing industry are to remain exempt, clearly small business concerns which regularly compete with the big corporations should also be exempt from the "at risk" tax rules intended for shelter operations only.

Recently, when other tax legislation was before the Senate for consideration, Senator Johnston of Louisiana prepared, in consultation with the staff of the Joint Committee on Taxation, an amendment which would have returned competitive tax equity and equality to the industry. A copy of that amendment is filed herewith for this Committee's consideration at this time. It is my understanding that Senator Johnston withheld his amendment at that time because he was advised by the Chairman that this was the type of tax inequity which could be promptly resolved by the Finance Committee when appropriate omnibus tax legislation was before it for consideration.

Certainly, H.R. 13511 is that type of tax legislation—and Committee action now is patently imperative since Title II of H.R. 13511 actually proposes blindly to expand "at risk" coverage to a broader spectrum of small business operations without making any attempt to cure the basic fallacy of the 1976 Act.

2. At the very minimum, those portions of the "at risk" provisions of Title II which (a) extend "at risk" to all small closely-held corporations (while their big business competitors remain exempt) and (b) require "recapture" of small business equipment leasing losses—must be rejected insofar as the equipment leasing industry is concerned.

3. As a final alternative, I understand the staff of the Joint Committee on Taxation, which is certainly aware of the many shortcomings and inequities of the new "at risk" concept as it applies to equipment leasing, has had under consideration for some time a Limitation On Artificial Loss (LAL) proposal for application to equipment leasing only which might serve concomitantly (a) to remove the gross inequities "at risk" imposes on small business concerns in the industry and still (b) accomplish the desired taxation of clear-cut equipment leasing shelters. If substitution of LAL for "at risk" in equipment leasing offers the only totally fair, viable solution for all competing interests, then certainly Congress must follow that course this year, without further delay. Any continuation of the tax *status quo* in the equipment leasing industry—or worse yet, the adoption of Title II of H.R. 13511 without effective modification—will surely destroy the small business segment of our industry.

4. It should be understood, of course, that correction of this major problem for the industry will not result in any substantial loss of revenues for the Treasury. Congress did not intend to apply "at risk" to regular office equipment leasing operations from the very outset, and thus, when the 1976 Act was passed, no revenue intake from these normal business operations was contemplated. In any event, the total taxes collected from these regular small business leasing operations each year is relatively negligible insofar as the Treasury is concerned, especially since the House and Senate Reports issued in support of the Tax Reform Act of 1976 estimated that only $14 million in new revenues would be generated

by fiscal year 1981 if all equipment leasing tax shelters become fully subject to the new "at risk" provisions of Section 465 of the Code.

The CHAIRMAN. Next we will hear from Mr. Robert O. Muller, executive director, Council of Vietnam Veterans.

STATEMENT OF ROBERT O. MULLER, EXECUTIVE DIRECTOR, COUNCIL OF VIETNAM VETERANS, INC.

Mr. MULLER. I have two associates that I would like to join me, if that is possible.

The CHAIRMAN. Certainly.

Mr. MULLER. With me are Stuart Felman, who is our counsel, and Mr. Steve Champlin who is our staff person, and who did much of the work on this provision.

We have prepared a somewhat lengthy statement that we would like to submit for the record, and if I may I would like to give a narrow summary.

I appreciate the chairman's indulgence, since we are not addressing the major considerations in this bill. We are focusing on what might be considered as one tree out of a rather large forest, specifically, the provision which will create a targeted job credit for hiring certain Vietnam veterans.

I think perhaps at the beginning it is fair to say that it is a sad comment that in 1978, fully 10 years after the TET offensive, we are still here trying to get some employment relief for the Vietnam veteran, who is now an average of 33 years of age. But such is the case.

The employment initiatives to date have been a dismal failure in providing employment relief to the Vietnam veterans. This is not our conclusion alone. In a survey conducted of Congress earlier this year by Joe Nepolitan for the council. Members of the House and Senate were asked what was their assessment of the employment initiatives which have been afforded to the Vietnam veterans. Only 13 percent felt that the employment programs had been successful, and over 50 percent of the members said that they had been a dismal failure.

The reasons for this are very lengthy and involved. Let me simply say that the Veterans Affairs Committee has repeatedly, over the years, held hearings that have identified the failures of programs, chastized the Department of Labor, as well as others, repeatedly, only to have the same problem recur the next year, when they come before the House again.

This is one of the reasons that the tax credit is particularly attractive to us, because it can circumvent those particular Government mechanisms and systems which do not work, which cannot do the job, which are perhaps even more harmful than nothing, because they provide the illusion that something is being done, for the Vietnam veteran.

This tax credit provision essentially puts the veteran in a bargaining position, where he can go directly one on one to the employer, and it can be IBM, or the gas station around the corner, and say: "Look, my friend, there is an affirmative action program, you know about that, and I am covered by it. But I am here to tell you that if you employ me, there is something else in it for you as well. There is a $3,000 tax credit the first year, and a $1,000 tax credit the second year." That should be a sufficient incentive for the employer to give some serious consideration, finally, to the Vietnam veteran.

I think that this is a program which will work. The Vietnam veteran who is targeted to be assisted by this program is the one who is still in receipt of food stamps. To think that in 1978, the guys who fought 10 years ago are still on food stamps, this is sort of a sad comment on where we stand in this country.

Additionally, I think you should understand that the readjustment programs that have been afforded to the Vietnam veterans have not been equal to the programs afforded veterans of other wars. Even now, Administrator Max Cleland was candid enough to admit in a recent "Issues and Answers Program" on NBC, that until 1974, the amount of assistance afforded to Vietnam veterans under the GI bill was not adequate, and denied effective utilization of the benefits.

That is partly, in toto, why the studies which have been coming out over the past year have indicated that among Vietnam veterans, you have significant readjustment problems effecting as high as 40 percent. To have 40 percent of the guys who fought in 1968 still having readjustment difficulties is unconscionable.

That is the reason that we are coming before you today, and strongly encouraging your support in this much needec provision.

The CHAIRMAN. Let me say just one thing, which to me is important.

I have no problem whatever in supporting a targeted tax credit to anybody who suffered a disability that is ratable by the VA. For that matter, I could actually go along with something for the man who has actually spent a year in Vietnam. But if a man has no disability, and simply went to a military base for a few months, and really never had a shot fired at him in anger, never even went overseas, do you really think that we ought to target something on him, compared to some other people who have done some useful national service, such as the fellow who won a gold medal at the Olympics, and gave us some nice national recognition during this period, and since that time?

Mr. MULLER. Mr. Chairman, for fear of turning the scope of the discussion into an area I do not want to get into, let me give you a simple, honest reply.

The CHAIRMAN. Frankly, I helped to write the veterans law for the State of Louisiana before I came up here. For someone who died in action, the State paid $1,000. If a fellow actually went overseas, or spent a year in uniform, he got $250. If he just went to a base, and did a little marching around for less than 90 days, and then was discharged, we did not feel that we owed him more than $25. We thought that we were being very generous to give him that.

Why shouldn't we use the same philosophy on this?

Mr. MULLER. I have to share a very quick experience with you.

First of all, I was shot in Vietnam, and I am 100-percent service-connected disabled. When I came back, I was in a military hospital. I had a representative from the Veterans' Administration come up to me one day and advised me that I was going to get a lot of money. You can believe me, I am telling the truth. I asked him why. He said: "Because you were wounded."

I, and a lot of other guys, did not go into the military with the idea in mind that it was a quid pro quo type of an arrangement. It was an obligation that we had to our country that we did. We did not come back expecting a whole bunch of gratuities and lifelong benefits.

This question was called for me personally again, when I went to the veterans hospital where I spent a year, and I found out that the guy next to me had been in prison, and that is where he got messed up. The guy next to him had jumped off of the third floor of a mental institution because he was a lunatic. The one next to him was an alcoholic.

So that brought me to ask, "What do they have in this veterans hospital?" I later found out that only 13 percent of the cases serviced at the veterans hospital had service-connected disabilities.

This year alone, where you have a program on the House side of at least $900 million to reform the pension program for non-service-related needs, we cannot create the programs needed to address the service connected needs of the Vietnam veterans or those who are in need of readjustment.

So I think that the question you asked is a fair one. I feel personally about it. All I can say in response to it is that what this country does or does not do in response to its veterans programs is basically a subjective value judgment, which is reached on the basis of a consensus of those Members in Congress who generate the laws. That is the real policy parameter.

But, in addition, I have equally compelling experiences that suggest the tax program should include all veterans. I can just tell you that I was a marine infantry officer, and I had roughly a 200-marine infantry company that were not rear-echelon guys. These guys fought the war. One day my commanders came down to me and they said: "We need five members of your company with high school degrees, high school diplomas." We went through the entire company records, and out of 200 marine infantry guys that were fighting that war, we did not have 5 with a high school diploma.

That is why, when you are talking about the Vietnam veteran, you are talking about what I consider to be, in my experience over the years, a bunch of guys who had an extraordinarily raw deal, that have been called upon in very trying and difficult circumstances. Today, we are talking about veterans who, 10 years after Tet, are still on food stamps. They certainly deserve a measure of support and recognition from this country. That is why I would include all Vietnam veterans. I hope that is responsive.

The CHAIRMAN. You have made a very fine statement.

[The prepared statement of Mr. Muller follows:]

STATEMENT OF ROBERT O. MULLER, EXECUTIVE DIRECTOR, COUNCIL OF VIETNAM VETERANS, INC.

SUMMARY

The Council supports a targeted approach, or a targeted approach combined with a lower "general" credit similar to existing law. These alternatives combine a particular structure of the jobs tax credit that is advantageous to employers, with an incentive-based employment program that should allow veterans to discover jobs without using the existing and inadequate employment services. Under a targeted approach, veterans secure jobs on a face-to-face, employer-to-employer basis. Without targeting, these advantages disappear.

Vietnam-era veterans need a private sector employment program with serious employer incentives. Their present real unemployment rate is approximately 6.7

percent. Minority Vietnam-era veteran unemployment is significantly higher, and historically has been more severe than minority male unemployment generally. Public sector work programs are not responsive to their need for reliable and on going employment.

Vietnam-era veterans served in an unpopular war, and returned to an inadequate GI Bill. Despite frequent and repeated promises, and their persistent unemployment problem, they have yet to receive a serious jobs program. HIRE failed publicly and miserably. The President's promise of 35 percent of the new CETA positions resulted in their getting only 14 percent of the jobs.

Mr. Chairman, members of the Committee, the Council of Vietnam Veterans appreciates this opportunity to appear before you and to discuss the targeted jobs tax credit, Sec. 315 of H.R. 13511, amending Sec. 51 of the Internal Revenue Code.

Mr. Chairman, the Council strongly supports a targeted approach to the jobs credit and the inclusion of Vietnam-era veterans as one of the target classes.

Vietnam veterans served during a difficult period, in a war that was subject to constant reevaluation and no constant sense of purpose. Many, uncertain of the war's meaning, were certain only that the country through its proper processes had placed upon them a duty. They responded to that duty, but their lives bore the moral and emotional tumult of the times. Returning home, they became the visible symbols of the nation's unrest.

That war has been over for some time now. Recognizing this passage of time is crucial to any discussion of Vietnam-era problems. For while the war is gone, the veteran remains and grows older. He is now average age 33. He is married. Accordingly, when we are talking about the employment problems of Vietnam-era veterans, we are talking about a group that is entering into middle age, but has yet to break into career oriented employment, whether white collar or blue. We are talking, in many cases, about lives that have been shaped by a pattern of unemployment and underemployment. That is the first and central setting of any proper policy.

Vietnam-era veterans returned to an economy that historically, year after year, treated them poorly. The Vietnam-era veteran's average aage was 23 at the time of separation and had at least two years of employment history in the service. Yet upon their return, they faced consistently disproportionate unemployment rates. From 1969, the earliest period for which we have statistics, until today's statistics for July 1978, unemployment for the recently separated veteran, age 20–24, has been higher than unemployment for their nonveteran peer.

Similarly, the unemployment rate for veterans aged 20–34 from 1969 to 1977 averaged an unacceptable seven percent. That figure is not a statistical construction of artificial averaging. Throughout that eight-year period, the unemployment rate for veterans aged 20–34 fell below 6.6 percent on a yearly basis only twice. The veteran unemployment rate was higher than the rate for male nonveterans their same age year in and year out from 1969 until 1974. From 1975 through the first half of 1977 the best that can be said is that it was hard on every one and the Vietnam-era veteran suffered with his peers through a recession that produced unemployment rates for veterans aged 20–34 of 9.3 percent in 1975 and 7.9 percent in 1976.

Those years of bleak employment prospects have also been marked by the broken promises of inadequately designed and delivered veteran employment programs. Again and again the national government has acknowledged its obligations and with great fanfare promised responses. Most recently, in the beginning of 1977, President Carter promised veterans $1.3 billion in public sector jobs (35 percent of new openings) under CETA, and 50,000 to 60,000 private sector employment places under HIRE. Most Americans probably assume a commitment of that size meant the problem had been solved. But, in reality, HIRE failed so completely and so quickly that its obituary has been consigned to the archives and veterans, far from getting an increased number of CETA positions, were worse off at the end of 1977 than they were in 1975: 6.5 percent of Title VI, compared to 12.5 percent in 1975; 7.4 percent of Title II, compared to 11.3 percent in 1975, (for "special" veterans—those who served in Southeast Asia).

Today, as we discuss a $30 to $50 million tax-credit proposal, we sit on the bones of billions of dollars worth of dead promises.

This history of employment problems provides the second central setting for Vietnam-era veteran employment policy. We are not addressing a problem defined just by some needs of this year, next year or last year. We are turning to address a problem that has existed for some time and that requires from us that special deference which persistence deserves.

It is within this setting of both a historically recurring problem, and the lives of older veterans that have had to deal with that problem, that I turn to the issues of the present moment and to discuss:

I. The Need for an employment program addressing Vietnam-era veterans;

II. The Inadequacies of Existing Programs and the Advantages of a Tax Credit approach toward meeting those needs;

III. The Advantages of a Targeted Use of a Jobs Credit; and finally

IV. An Evaluation of the Alternative Jobs Credit Approaches.

THE NEED

The history of Vietnam-era veteran unemployment has left a major residue. That residue forms a pressing contemporary problem.

A. *Underemploment.*—During 1976, according to the most recent VA census figures, 1.8 million veterans aged 20–34 earned less than $7,000. That is 26 percent of the 6.9 million veterans that age. Eight hundred and fifty-five thousand of these veterans earn less than $4,000 a year.

This underemployment problem also appears if we look at length of employment instead of income. Of the 6.1 million veterans aged 20–34 who secured full-time work during 1976, the latest available figures, one million worked 39 weeks or less with nearly 700,000 working a half year or less.

B. *Minority Unemployment.*—According to the Bureau of Labor Statistics, the unemployment rate among black veterans aged 20–34 during the last quarter of 1977 was 16.2 percent, higher than the 12.6 percent unemployment rate for black nonveterans. During the first quarter of 1978 unemployment among black Vietnam-era veterans improved slightly, but reached only 14.1 percent. Again, the unemployment rate for black veterans aged 20–24, 25–29 and 30–34 remained higher than the rate for their black nonveteran peers. Similarly, while unemployment among black nonveterans had gone *down* for every age group, unemployment among black veterans 30-34, as well as black veterans aged 20–24, had gone up over the previous year.

C. *The Real Unemployment Rate.*—Accordingly, while the unemployment rate for Vietnam-era veterans has (in BLS statistics) gone down significantly over the last series of quarters, there are still real problems.

These problems become more apparent when we recognize some significant problems that compromise the BLS figures on "Vietnam-era" veteran unemployment. First, their figures for "Vietnam-era" veterans actually only measure veterans by age and cut off at age 34. However, Vietnam-era veterans are now average age 33. According to the Department of Labor itself, in order to obtain an accurate picture, it is necessary to add 100,000 veterans from the Vietnam-era over age 34 and unemployed. That brings the July numbers up to 414,000. But in addition, DOL claims 160,000 veterans in "temporary public service employment" who will, as the DOL puts it, be "requiring assistance in transitioning to unsubsidized employment." That brings the effective numbers needing help up to 574,000. With 8.5 million Vietnam-era veterans, around half of whom are over 33, that gives us a real unemployment rate of 6.7 percent with the unemployment rate for men generally, 20 and over being 4.1 percent and for male nonveterans aged 20–34 being 5.9 percent.

D. *Cyclical Unemployment.*—Once before, in an inflationary full employment economy, veterans' unemployment went down. But as the economy changed, some 200,000 veterans who had been the last hired became the first fired, and the improved statistics changed back into disaster for them.

The marginal occupations of some 25 percent of the veterans aged 20–34, as well as the continued, disproportionately severe unemployment among black veterans, have suggested that the recent upsurge in unemployment may have the same cyclically sensitive character.

Regrettably, that suggestion seems now on the way to confirmation. Unemployment went up during July. Veteran unemployment, however, showed a disproportionate increase. This increase is particularly important when it is recognized that, according to the Bureau of Labor Statistics, "Teenagers accounted for half of the 440,000 increase in unemployment in July, as their rate rose from 14.2 percent to 16.3 percent. Most of the remaining increase occurred among adult women, whose rate advanced from 6.1 to 6.5 percent." ("The Employment Situation: July 1978," p. 1). Women and youth are positioned in the market in ways that make them disproportionately sensitive to summer seasonal pressures. Veterans, accordingly, stand out as a major male adult group to be severely hit.

This sensitivity can be spelled out in detail by compassing veteran unemployment rates to that of their male peers.

Unemployment among veterans aged 20–34 went up .8 percent to 5.1 percent, as distinct from unemployment for male nonveterans aged 20–34, which only went up .4 percent. Unemployment among veterans aged 20–24 went up to full 2 percent, to 11.4 percent, again significantly more than male nonveteran unemployment, which only went up .5 percent. Similarly, unemployment among veterans aged 25–29 went up a full 1.1 percent, while for nonveterans it only went up .6 percent; and for veterans aged 30–34 it went up .3 percent while for nonveterans it went down .4 percent.

	June	July	Amount of increase	Percentage increase
Veteran:				
20 to 34	4.3	5.1	0.8	18
20 to 24	9.4	11.4	2.0	21
25 to 29	5.3	6.4	1.1	20
30 to 34	2.6	2.9	.3	11
Male nonveteran:				
20 to 34	5.5	5.9	.4	7
20 to 24	7.9	8.4	.5	6
25 to 29	3.8	4.4	.6	15
30 to 34	3.7	3.3	−.4	−10

The statistical cautions that must apply to the use of any BLS monthly trend are appropriate, but equally appropriate is the sense that history may be repeating itself.

This concern is made particularly acute by two present policies. First, the Administration appears to be focusing its concern on inflation. The result should be at least slower growth, if not a small or "growth recession." Second, there is an increasing tendency to declare the veteran unemployment problem over and target employment programs away from them.

The continued conjunction of these two policies will force veterans to pay a double price for overall economic planning. On the one hand, due to increasing attempts to control inflation they would be thrown out into unemployment. But on the other hand, once unemployed, they will find that they have been written out of employment programs because of the alleged end of their employment problems.

INADEQUACIES OF EXISTING PROGRAMS: ADVANTAGES OF A TAX CREDIT

With Vietnam-era veteran underemployment and unemployment remaining a serious national problem, the question becomes whether the existing programs are adequately addressing the need. The answer unfortunately is no. But in addition, the failures barring existing programs from successfully fulfilling their functions have been structural, and not merely inadequate implementation. The tax-credit approach offers an unusual opportunity because it corrects these structural problems.

A. *Structural Advantages of the Tax-Credit Approach Over CETA.*—The largest single employment program reaching veterans is CETA. But CETA places veterans primarily in public sector employment through what is presently Title II and Title VI jobs. Vietnam-era veterans, however, who are older need private sector employment, or they need career oriented public sector employment which CETA was not designed to provide. As distinct from CETA, the tax credit provides private sector employment and should help to return veterans to the career tracks they so desperately need.

But, in addition, public sector work project employment is short term. It ends and confronts veterans with the need to bridge over into private sector employment. This is particularly the case under Title VI of CETA, which is purposefully short term, limited from 12 to 18 months. Transfer from a Title VI job to the private sector is difficult. The result is that Title VI employment tends to become a mere employment break in a career of chronic employment problems. The tax-credit approach again eliminates this problem at the threshold by bringing the veteran directly into the private sector. Under the House Bill, in addition, employers are provided a two-year incentive that should help veterans establish a serious and continuous employment history.

B. *Structural Advantages of the Tax Credit Over the VA On-the-Job Training Program.*—Title 38 of the United States Code establishes in Sec. 1787 an apprenticeship and other on-the-job training programs. The program pays veterans a supplemental income when they take part in a certified apprenticeship or on-the-job training program in a firm or other organization. As distinct from CETA, the program is private sector oriented. However, it is marred by basic and crippling problems.

The Tax Credit Minimizes Governmental Supervision

The on-the-job training program entails significant employer disincentives due to governmental supervision. Qualification under the program is dependent on the employer meeting one of two tests: either an apprenticeship program that clears the infamous DOL standards or an on-the-job training program that clears a set of special VA standards. Those VA standards, mandated in Sec. 1777 take up one full page of very small print in the statute alone.

In contrast, the tax-credit program is being designed to minimize governmental supervision. Most importantly, it simply side steps entirely the "training" boondoggle.

The Tax Credit Increases Monetary Employer Incentives

The Veterans Administration has itself acknowledged that its on-the-job training program is held back by a lack of any serious employer incentives. Under the VA's on-the-job training program, funds are not paid to the employer, but are rather paid as a supplement to the employee. The result is that the only incentive to the employer is the increased likelihood that the employee will remain on the job due to the increased income the employee is receiving from the VA.

While the VA program was once attractive, it has now been outstripped by the last generation of government programs which provide significantly larger employer incentives. It is no longer competitive. The result has been a quickly plummeting usage rate. Enrollment under the program has declined 50 percent over the three years between 1974 and 1977.

C. *Flexibility of the Tax Credit as a Response to Cyclical Unemployment.*—The tax credit offers an unusually flexible response to any increased unemployment that might result from a contraction in the labor market due to governmental efforts to control inflation. Should unemployment increase and the economy slow down slightly, the tax credit underwrites employment begun in 1979 and assists employers in maintaining present employment by replacing any turnovers. And it does that at an incredibly low expense compared to CETA. On the other hand, should the economy not contract the tax credit does not entail the extensive allocation of funds that would then be spent providing increased stimulus or the placing in position of a massive job program that might not have a real function.

ADVANTAGES OF A TARGETED APPROACH

A. *The Targeted Approach Both Increases the Certainty With Which a Credit Can Be Claimed and Controls the Employer's Paperwork.*—The targeted tax credit does not create new regulations where none existed before. Under present law, employers can only claim a credit for an employee if the slot filled by that employee is part of an increase in total employment of at least 2 percent over the previous year. The employer must certify that such an increase has occurred in order to secure the credit

The targeted approach substitutes a concern with the employee for the present concern with an increase in total employment. The result is that an employee must be from one of the specified classes. Given that, however, an employer need not certify that the employee filled a new slot.

Any increase in paperwork that flows from the bill stems from the new direction of regulatory concern. The paperwork, however, is carefully controlled. Employers have no responsibility for determining that an employee is from the target class. The bill specifically places that burden upon the government (Sec. 51(c), Report p. 92). The employee receives from the government certification that can be relied upon by an employer without risk. An employee, for example can simply present to an employer the certification as part of the negotiation for the job. The employer's total responsibilities would consist of filing the certification (Report p. 93).

What this limitation on the paperwork cannot minimize is the shock of the new. While new paperwork is controlled, employers are nevertheless required to retool their thinking. Having mastered an old law, they must now master a new one.

But in return for the new law, employers are given a much more certain tax credit. Under existing law, the employer must account for the increase through calculations of past and present wages. The Internal Revenue Service informs us that the calculations and limitations on allowable wages have created significant difficulties. While some of these difficulties are perhaps due to unnecessary complexities in the forms, the problem is inherent to any credit that is uncertain until tests are met that are subject to audit and require calculations. The deduction is necessarily uncertain until it is allowed by the Internal Revenue Service.

In contrast, the targeted approach moves all accreditation to the front end. Under the House Bill potential employees are required to themselves secure a certificate of eligibility, but an employer upon receipt of the certificate can rely upon it without risk. The credit can be claimed with certainty and without potential for audit. There are no calculations, no other tests.

But the certainty of the credit is also increased by the independence of the targeted credit from any dependence on other variables. Under the existing law an employer may foresee growth, hire an individual expecting to underwrite the salary in part and then be hurt by an unusually weak season and be forced to contract. Unfortunately, when the employer contracts the credit is lost. The result is that a credit designed to underwrite growth is inhibited in doing that because an employer's ability to count on the credit is dependent on all the factors that make up his market conditions.

Under the targeted approach, however, a credit once exercised is certain. No matter what happens to the employer through the rest of the fiscal year, the credit remains.

For employers that means flexibility. If an employee does not work, or if the market changes, an employer can still count on the credit. That also means that an employer can run immediate cost-return calculations on the basis of fixed and certain revenue gains from the credit.

B. *The Targeted Approach Provides Greater and More Equitable Opportunity for Employers to Claim a Credit.*—The existing law, which provides a credit for any increased employment only, is in effect targeted to areas and industries that are growing. Inner city business, or business in areas of rural poverty, as well as industries that are not characterized by growth or are presently not undergoing growth periods, are in effect excluded from claiming the credit. But in many cases these are precisely the areas that should be helped.

An explicitly targeted credit is in reality not much more targeted. Properly drawn, it merely allows all areas to take advantage of the credit, without creating disproportionate budget impact, by targeting in on needy employees and not types of employers.

But not only is the targeted approach more equitable, but it also creates increased opportunities to claim the credit. Under the targeted approach, the employer need not show growth and, accordingly, normal turnovers can result in a credit.

This increased opportunity may become increasingly important in the coming months. Last month's unemployment rate went up. The number of employed individuals declined by 400,000. The Administration's increasing concern to control inflation may result in further decreases in employment.

But the existing law is only truly available during a period of economic growth, as measured in terms of employment. During a period of slower economic growth, fewer employers may be able to meet the threshold test of increase in total employment and may not be able to claim the credit, minus a change in law.

The targeting approach, accordingly, has an independent economic justification. The approach serves as a vehicle for adjusting the tax credit mechanism to periods of slower economic growth. Nor is this economic advantage won at the expense of abandoning the growth incentives under existing law. Employers can claim the credit while expanding merely by hiring new employees from among the target classes.

C. *The Targeted Approach Eliminates the Need for Employment Services and Other Outreach Vehicles, Placing the Veteran in Direct Contact With the Em-*

ployer.—Under existing law, a veteran can secure a job developed by the tax credit only if the veteran happens to be there around the time the job opens. There is no incentive for the employer to seek out the veteran. But the only way the veteran can be knowledgeable about the job is through the existing employment services or outreach vehicles.

Veterans, unfortunately, do not fare well in those vehicles. For example, one of the largest employers, and one we have statistics for, is CETA. CETA listings are theoretically made available to veterans through the general employment service network. In early 1977, shortly after his inauguration, President Carter announced a program to target 35 percent of the new CETA jobs to Vietnam-era veterans. President Carter's efforts followed on efforts of Congress to develop special eligibility standards and otherwise encourage the participation of Vietnam-era veterans. But yet fiscal year 1977 and first quarter 1978 rates were the same or lower than fiscal year 1975 rates, and now it appears that these rates may significantly overstate participation, according to a recent draft GAO study. The kind of problems that have continued to plague the system are simply horrendous.

A targeted approach is significant because it allows veterans to simply sidestep this whole delivery service. On the one hand, employers have an incentive to spend a few moments and search their files to find veteran applications or to pay particular importance to a veteran who applies for a job. On the other hand, the veteran has something of value that he brings with him. He has a bargaining edge.

When three years of Congressional mandate, and one year of focused Presidential concern produces nothing, then it is time to reconsider the vehicle. Veterans have done that. The tax credit is attractive because it results not in "special consideration" or mandated "listings" or "file searches," but in simple, face-to-face encounters, employer to employee.

AN EVALUATION OF THE ALTERNATE DESIGNS OF THE TARGETED APPROACH

Three designs of a targeted jobs tax credit have established currency:

Entirely Targeted Approach.—Something like the House Bill which will limit the credit entirely to hires of employees from specified groups;

Either-Or Approach.—The targeted credit forms a first tier which is then matched with a second tier, allowing a credit similar to the existing law for any increased employment. There is a differential, providing a larger credit and a second year credit for hiring from the target groups;

Piggy-back Approach.—Employers can receive a credit as under existing law far any increase in total employment. In addition, however, they can receive an extra credit for any of the increased employment which is hired from one or another of the target groups.

These differences in design raise important considerations that strike at the ability to retain the basic advantages of a targeted approach.

The piggy-back design eliminates the advantages of the targeting approach. By limiting the incentive to only hires of targeted employees to fill increased positions, it eliminates the basic structural advantages of the targeting approach. Employers face the same uncertainties and accounting problems and the opportunities to claim the credit are confined within the existing limitations and inequities.

But in addition, by requiring that the increased employment test be met at the threshold before any credit can be claimed for the target populations, the piggy-back design limits the possible openings available for target hires. The ability to meet the needs of the target population is significantly decreased.

A purely targeted design raises, however, serious drafting questions. The equity of a purely targeted design is dependent on the geographical dispersion of the target populations. Without adequate dispersion, some employers from areas where members of the target classes are unavailable may, in effect, be written out of the program. Questions have been raised about the dispersion of the classes as defined in the House Bill, and it has been suggested that may be unacceptably concentrated in urban areas. This question must be carefully explored.

The either-or design avoids both of these difficulties, but only if an adequate differential is built in between the "general" or existing credit and the targeted credit. Without the differential, the advantage to the target population is severely jeopardized. Those with particular employment needs who are included within the targeted classes will be hired only where there is no growth or where an employer opts for the certainty and paperwork advantages that stem from the targeted approach. There will be an increasing need for employment services to convince employers of the need to hire from target groups and to serve as a vehicle for ensuring that members of the target groups know about potential openings. The incentive framework must be retained and carefully slanted toward the target groups.

The alternatives, then, seem clear. On the one hand, an either-or approach with a carefully drawn differential. On the other hand, a purely targeted approach that carefully addresses the need for geographical dispersion.

CONCLUSION

The sense of a nation's felt obligation can often be best gauged by the dimensions of its promises. If so, then the government's sense of obligation to the veterans of the Vietnam-era is probably best communicated by the $1.3 billion the President promised in early 1977. That promise remains unmet, but we hope that in the next few weeks the Senate will act to fulfill it in part.

[From The Washington Post, Jan. 28, 1977]

LABOR DEPARTMENT ASKS JOBS FOR 200,000 VIET VETERANS

(By Austin Scott)

Just hours after he was sworn in, Labor Secretary F. Ray Marshall announced a $1.3 billion, three-point program yesterday to find both private and public service jobs for more than 200,000 of the nation's 558,000 unemployed Vietnam-era veterans.

Marshall called the 8.6 per cent unemployment rate for male Vietnam-era veterans aged 20 to 34 a "blight on the nation's conscience," and said President Carter will "approach the chief executive officers of most of the major American corporations to request their support . . ."

He said he didn't know whether the program would blunt sharp criticism of Carter's pardon for draft evaders voiced by some veterans' groups. But he said he had worked extensively with veterans' groups to draft the job program, and he thinks they will support it.

Carter ordered him to give top priority to the problem during his first meeting with his Cabinet appointees on St. Simons Island, Ga., the week after Christmas, Marshall said.

He is most concerned about the disabled and black unemployed veterans, the "hardest hit of all," Marshall said.

The most recent data show an unemployment rate among younger black veterans of more than 20 per cent, Marshall said, compared with 18 per cent for all Vietnam-era veterans aged 20 to 24, 12.5 per cent for nonveterans of the same age, and 7.9 per cent for the nation as a whole.

The three major components of Marshall's program are:

A $100 million effort called HIRE that will try to persuade private business to create 50,000 to 60,000 new jobs and training slots for veterans. It will focus on the disabled first, then on all Vietnam-era veterans, and finally, if there aren't enough veterans in a given community, on "disadvantaged young jobseekers and the long-term unemployed."

Attempts to put veterans in at least 145,000 of the 1,035,000 public service jobs the Carter administration wants to create to ease unemployment. Those 145,000 jobs will cost about $1.2 billion, Marshall said.

A $20 million "outreach" effort that will place disabled Vietnam-era veterans in employment service offices in the 100 largest cities, with at least one such unit in each state. Those disabled workers will "concentrate on identifying disabled veterans in need of services and bringing them into the mainstream of the labor market . . .," as well as "developing private-sector jobs for disabled veterans . . ."

Asked how he would ensure that private companies would create new jobs, and not just "push unemployment around" by putting veterans in old jobs, Marshall said he intended to both tighten up administrative loopholes, and compensate employers only for the extra expenses they incur.

He said he hoped elimination of some red tape would keep private industry from opposing this program as it did the Nixon administration's JOBS program, which paid incentives to private businesses to create jobs.

Carter wants 35 per cent of all new public service jobs to be filled by Vietnam-era veterans, Marshall said, and will ask Congress to amend the Comprehensive Employment and Training Act (CETA) to allow "preference for Vietnam-era veterans aged 20-24 . . ."

That group bears the heaviest unemployment burden, he said, and more than 20 percent of the unemployed in that group are nonwhite.

Asked why he did not mention female veterans in his half-hour presentation, Marshall said "We don't collect, unfortunately, statistics on females. That's a thing we need to look at."

Marshall's announcement came four years to the day after the signing of the Jan. 27, 1973 Paris cease-fire on Vietnam, and almost exactly four years after the Nixon administration said unemployment among Vietnam veterans "in effect no longer constitutes a national problem."

President Nixon ordered a "jobs for veterans" program "of the highest priority" in 1971, to reduce what was then an 11 per cent overall jobless rate among Vietnam veterans.

By January of 1973, propelled by a still booming economy, the overall jobless rate among Vietnam veterans had fallen to 5.5 per cent, just slightly higher than the 5.2 per cent unemployment rate for the entire civilian work force.

Marshall said he wasn't sure why veteran unemployment is so high now, but the recession played a role.

The Vietnam Veterans Center in Washington complained that the 20-to-24-year-olds that Marshall focused on are too young to have served in Vietnam. They are mostly those forced into the all-volunteer Army by the recession, a center spokesman said.

[From the Washington Post, Apr. 28, 1977]

Promises of Jobs Unfilled, Vietnam Veterans Assert

[By William Greider]

Back in January, the Catrer administration got a lot of big headlines for proclaiming new job programs for unemployed Vietnam veterans, but those early promises have already soured for many veterans' organizations.

Meanwhile, unemployment among Vietnam veterans is rising.

"They've been dragging their feet for three months," said Austin E. Kerby of the American Legion, complaining that the Labor Department has not yet even filled the new position created for the program, deputy assistant secretary for veterans emplyoment.

"Our high hopes," said Lawrence W. Roffee Jr. of Paralyzed Veterans of America, "have now turned to frustration and cynicism. In our opinion, the way the programs have been developed there is little chance of making any significant reduction in the unemployment rate."

"We are now into the fourth month of the new administration," said Ronald W. Drach of the Disabled American Veterans, "and we have seen the immediate implementation of several programs to assist those who evaded the draft and those who failed to serve honorably during the Vietnam-era. However, we fail to see any concerted effort to assist all disabled veterans who served their country honorably . . ."

"What I hear," said Thomas J. Wincek, veterans coordinator at the University of Minnesota, "is that the veteran is No. 1. But what I see is that veterans really aren't that important and programs to help them can be dropped or neglected."

At the same time, unemplyoment among veterans jumped a point in March to 17.1 percent—nearly 7 percentage points higher than non-veterans of the same age.

The growing frustration of veterans with the Carter administration—in particular with the Labor Department's job agencies—has been gathering momentum for weeks and was expressed yesterday by seven widely varying veterans organizattions at a hearing of the House Veterans Committee.

On the whole, they see the Carter administration, promises notwithstanding, repeating the bureaucratic stall and dribble which frustrated them under Republican Presidents—and left veterans with a disappointing share of the federal job-and-training benefits handed out under labor Department programs.

Labor Secretary Ray Marshall on the day he was sworn in announced three new programs, totaling $1.3 billion. Labor is still waiting for Congress to appropriate most of the money under the $4 billion economic stimulus legislation, but the veterans groups are already deeply skeptical about how much will actually get to veterans.

For instance:

The Carter administration promised 145,000 slots for veterans under Labor's public-service jobs program and a veterans preference up to 35 percent on all new job slots for young Vietnam veterans.

After the guidelines were published, the Veterans of Foreign Wars fired off a telegram to the White House, complaining that these goals were evaporating into vague instructions which merely encouraged local city halls and other program sponsors to sign up vets. In the past, Vietnam veterans have fared poorly when these jobs were handed out and their organizations want strong guarantees of veteran priority.

"Could it be possible," the VFW asked, "that an underling in the Labor Department solicitor's office can change the President's announced program or did Secretary Marshall mislead the American public and those who served honorably?"

Labor's proposed legislation—which the veterans complain was poorly drawn and offered to Congress without much push—was rejected by the House when it renewed the jobs program. The House would prefer to keep the jobs money free of categorical guarantees for any specific groups.

Another component called HIRE, a $100 million subsidy program for private businesses that hire veterans, is also awaiting funds through Marshall's remarks in January left veterans groups, as well as some senators, with the impression that HIRE would proceed immediately. At the moment, Labor is planning a publicity ceremony at the White House sometime soon when the President appoints a HIRE advisory committee of business leaders.

The third program called Outreach envisions $20 million for hiring 2,000 disabled veterans to help other disabled vets in the job market. As of yesterday, according to a department spokesman, about 500 of these have been recruited.

A major thrust of the veterans complaints is aimed at the U.S. Employment Service and other Labor bureaucrats who are accused of slighting veterans in the past. The same people, according to the veterans, are running the programs under the Carter administration. A Veterans Employment Service created to eliminate these problems has been ineffective because it reports to the same people, the vets complain.

"An anti-veteran attitude," Kerby of the American Legion charged.

[From the Washington Post, Nov. 18, 1977]

Frank Greve—A Legacy of 'Lost' Veterans

In Dupont Circle, a dozen ragged men sit nodding in the sun.

They are Vietnam veterans who have found their niche in vagrancy.

One of them flips an empty bottle that once held cheap wine over his shoulder, and it smashes to the sidewalk. Another passes around a shoplifted can of Vienna sausage for lunch.

Mostly, as one of them says, they "play music, smoke reefers, drink wine, talk. Hate one another. Care about one another." Mostly, that is they do nothing.

There are an estimated 40,000 to 50,000 veterans just like them across the country. They are turning up in parks and flophouses, and according to surveys by the Bureau of Labor Statistics, they have no desire to work or they have given up looking.

And this is just one of the disturbing trends appearing among the 6.7 million veterans who served between August 1964 and May 1975.

Some of the others:

An estimated 500,000 are in criminal-justice custody—125,000 in jails and prisons and the remainder on parole, probation or some form of pre-trial release.

Another 511,000 are looking for work and can't find it, as unemployment among Vietnam veterans once again exceeds the rate for nonveterans. This phenomenon, unique to the Vietnam era, seemed to disappear in 1974, but has reappeared in the wake of recession, industry cutbacks and reluctance of companies to expand.

Currently, 7.7 percent of the veterans are unemployed, compared with 7 percent for those aged 20 to 34 without military service.

Among both the jailed and the unemployed, minorities are markedly overrepresented. "Black veterans have an incarceration rate almost double that of nonvet blacks the same age," says Neal Miller of the American Bar Association (ABA), studying the problem for the Department of Labor. He has also found that "black veterans are incarcerated at seven times the rate of white vets." But white veterans are only half as likely to wind up in jail as white nonvets, he has found.

In the job market, black veterans appear to suffer both an antiveteran bias and the traditional minority problem: an unemployment rate twice as high as that for whites. Hardest hit of all are young black veterans, aged 20 to 24, whose September unemployment rate was 30.5 per cent, a peak for the postwar era.

New job programs for veterans undertaken by the Carter administration have not done much to offset those numbers. A year ago, 529,000 Vietnam veterans were unemployed. The current 511,000 figure represents a drop of only 18,000 during what was hailed as a recovery period.

The Vietnam veterans are rapidly becoming a lost generation, says Roland Mora, Deputy Assistant Secretary of Labor for veterans' employment. "It's simple: The Vietnam vet got shafted when he went and shafted when he came home."

Mora, a former Marine captain who was disabled in Vietnam, was an advance man in Jimmy Carter's campaign. His post is new, created by Carter to show concern for young veterans.

"My feeling is that we're in a new era of Reconstruction," Mora says. "The hostility and bitterness that's still alive between North and South came from that period, and I'm afraid the post-Vietnam era could have the same long-term residual effects. I see it happening particularly with minorities, where the unemployment is so much worse."

Mora and most other analysts suspect that government figures, as bleak as they are, understate the problem.

"It's just a guess," Mora says, "but I think I know some places where, for every vet they count, there are two they miss who've just chucked the system. In every big city, which is where the problem is biggest because that's where the minorities are, you'll find whole networks, whole undergrounds, of vets who've just dropped out."

He blames discrimination by employers against minorities, compounded by discrimination specifically against veterans. "They see 'em as drug addicts," Mora says, "which is one of the worst raps Vietnam vets got. They [the employers] want to forget the war, so they forget the vet."

Arguing that "the Vietnam vet absorbed the guilt of this country," Mora predicts that "as time goes on, we'll see more and more psychological warfare between the vets and the civilians they fought for."

Miller of the ABA, from his data on prisoners, concludes only that "something is going on out there that we don't understand." His study is "picking up two kinds of people: people on drugs and people starting to explode." About a third of the incarcerations involve offenses linked to drugs, he says, followed in order of frequency by armed robberies, burglaries, murders, manslaughter and aggravated assault.

In addition to general discrimination against blacks, he adds, another explanation for the extraordinary unemployment among minority veterans is that "they were only about 10 per cent of the forces, but they had 50 percent of the combat roles. These, traditionally, are the worst preparation for civilian jobs."

"I was a paratrooper," says a black man, 30, in Dupont Circle, who answers "Naah" and shakes his head when asked his name. "I went down the employment service with a guy had been a truck driver. They told him: 'Try the bus station.' They told me: 'We ain't got no jobs jumpin' outa planes.' "

Occasionally, the argument is made, as by Veterans Administration spokesman Julian Morrison, that "these guys are no different from other groups of vets at the same stage of time after World War II." Morrison claims that "figures" back him, but VA statistician William Malloy disagrees.

"Nobody has ever compiled that data," Malloy says, "but the World War II veteran certainly didn't have a recession problem when he came back. And employment of vets always ran ahead of nonvets after World War II."

Meanwhile, in Dupont Circle, the vets talk about their fear of a rival park group: "The cons," says a man named Sam. "They'll kill you faster, stick you faster. Try to make a faggot outa you. Tell you you ain't nothin' but a hired killer Tom."

And they talk about their fear of the cold, when they must find and defend "a huddle": a warm sleeping spot in a laundromat, a basement or an apartment hall. "Generally, you drink more in winter," says Sam, "Wild Irish Rose, which is 20 per cent, or Gilbey's vodka. You drink as much as you need to go to sleep."

[From the Washington Post, May 29, 1978]

COLEMAN MCCARTHYS—VIETNAM VIETS: DOES CONGRESS FINALLY UNDERSTAND?

This Memorial Day it is worth nothing, and perhaps celebrating, that Vietnam veterans are less alone in being dissatisfied with their current mistreatment. Veterans whose needs for schooling, jobs, health care and readjustment aid have been ignored or met grudgingly have been joined by some members of Congress who share the despair.

A survey released today by Rep. David Bonior, a first-term Michigan Democrat who has come forward as a forceful ally of Vietnam-era veterans (he has organized a bloc of 13 of them in Congress), reveals a sentiment that until now has not been known in detail. The survey is based on a questionnaire return by 109 Senate and House members. Although that number is not large enough to be representative of the whole Congress, it does offer an accurate glimpse of what a significant percentage thinks. The findings include:

Only 14 percent think President Carter's $1.3-billion jobs program is a success, while 54 percent say it is not.

Fifty-five percent say the country js not doing enough for disabled veterans. Only 23 percent said it is.

The Veterans Administration earned a favorable rating of 73 percent for its care of all veterans but only 45 percent for Vietnam veterans. Fewer than 2 percent say the VA is doing poorly for all veterans, but 17 percent believe it does poorly for Vietnam veterans.

Seventy-six percent think the Vietnam veterans are dissatisfied by the government's treatment of them, with only 13 percent feeliing that the dissatisfaction is not justified.

These revelations, among others, of congressional attitudes suggest that the plight of Vietnam-era veterans is finally beginning to be understood. That it has taken this long may be due to the deference Congress has given to Reps. Olin Teague (D-Tex.) and Ray Roberts (D-Tex.). As enlightened as they may have been in aiding veterans from World War II and Korea, they have had blocks about Vietnam and its aftershock. Two findings in the survey counter the views of Teague and Hoberts: First, fewer than half of these polled say that Vietnam veterans command as much respect as veterans of World War II or Korea and, second, 86 percent said that lack of respect came from the "unpopularity of the war."

Outside of Congress, the findings of the survey may embolden Max Cleland, head of the VA, to be a stronger advocate than he has been for Vietnam veterans in certain issues. In last year's debate on the GI Bill amendments, for example, Cleland backed off from an earlier position of taking into account the higher tuition costs in some areas of the country. Instead, he backed a more limited plan that had the blessing of Teague and Roberts. In the survey, 64 percent of the lawmakers who responded favored legislation that would take tuition differences into account, while only 28 percent opposed it.

Meanwhile, Cleland and Stuart Eizenstat, the president's domestic affairs adviser, have submitted to President Carter a presidential review memorandum on the government's programs for Vietnam veterans. The report was seven weeks overdue. In addition to being handed in late—which says something about the administration's interest in the issue—the report may also be weak. Initial drafts reportedly minimize the ordeals suffered by many veterans.

If that's the case, then the survey may prove to be even more crucial to establishing a creative and comprehensive policy for Vietnam veterans. With a significant number of those in Congress now among the dissatisfied, it is less and less possible to say that all is well on the Vietnam front.

Last week, Cleland was asked in an interview in U.S. News and World Report if Vietnam veterans "have had a raw deal in comparison with veterans of other wars." He said, "There's a grain of truth to it." The congressional survey indicates that enough grains are on hand to fill a bin.

The CHAIRMAN. Senator Bentsen will be conducting a hearing at 2 o'clock. We will resume on schedule at 2 o'clock, when Senator Bentsen will be here.

[Whereupon, at 1:45 p.m., the committee adjourned, to reconvene at 2 p.m., the same day.]

REVENUE ACT OF 1978

[To Consider S. 3370]

THURSDAY, AUGUST 24, 1978

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

The committee met, pursuant to recess, at 2:02 o'clock, p.m., in Room 2221, Dirksen Senate Office Building, the Honorable Lloyd Bentsen presiding.

Present: Senators Bentsen, Haskell, and Curtis.

[The bill S. 3370 follows:]

33-050—78——15

95TH CONGRESS
2D SESSION

S. 3370

IN THE SENATE OF THE UNITED STATES

AUGUST 2 (legislative day, MAY 17), 1978

Mr. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To suspend certain Treasury Department and Internal Revenue Service action dealing with State and local financing.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ARBITRAGE AND REFUNDING OF INDUSTRIAL DEVELOPMENT BONDS REGULATIONS.

(a) IN GENERAL.—No arbitrage regulation or industrial development bond regulation shall hereafter be issued—

(1) in final form on or after August 1, 1978, and on or before December 31, 1979, or

(2) in proposed or final form on or after August 1, 1978, if such regulation has an effective date on or before December 31, 1979.

II

(b) DEFINITION OF ARBITRAGE REGULATION.—For purposes of subdivision (a) and section 2, the term "arbitrage regulation" means a regulation issued purporting to carry out or relating to the purposes of section 103 (c) of the Internal Revenue Code of 1954, as amended.

(c) DEFINITION OF INDUSTRIAL DEVELOPMENT BOND REGULATION.—For purposes of subdivision (a) and section 3, the term "industrial development bond regulation" means a regulation purporting to carry out or relating to the purposes of section 103 (b) of the Internal Revenue Code of 1954.

SEC. 2. ABOLITION OF CERTAIN ARBITRAGE REGULATIONS.

The proposed amendments to the income tax regulations (26 CFR part 1) under section 103 (c) of the Internal Revenue Code of 1954, published in the Federal Register May 8, 1978, and Revenue Ruling 78-302 and the accompanying Department of the Treasury, Internal Revenue Service, Information Release 2018 of July 20, 1978, shall have no force or effect and are declared invalid.

SEC. 3. ABOLITION OF CERTAIN INDUSTRIAL DEVELOPMENT BOND REGULATIONS (EXEMPT ACTIVITIES ONLY).

The proposed amendments to the income tax regulations (26 CFR part 1) under section 103(b) of the Internal Revenue Code of 1954, amending section 1.103-7 of said regulations published in the Federal Register December 6, 1977, as such proposed amendments relate to obligations issued after May 1, 1968, or January 1, 1969, if the transitional rules of section 1.103-12 of the income tax regulations are applicable, to provide "certain exempt activities" as defined in section 103(b)(4) of the Internal Revenue Code of 1954, as amended, shall have no force or effect and are declared invalid.

Senator BENTSEN: The hearing will come to order.

Mr. Secretary, would you take the witness chair, please.

On August 2, I introduced S. 3370, which would suspend until the end of 1979 certain Treasury Department and IRS actions relating to municipal bonds, which could have a serious impact on important governmental functions in States.

Officials of the State of Texas have informed me that recent administrative interpretations of section 103 of the Tax Law would frustrate efforts of State and local governments to carry out normal public financing functions.

Unreasonable Federal regulations that drive up State and local costs at no benefit to local citizens cannot be.

The purpose of this hearing this afternoon, which was organized at my request, is to enable the Finance Committee to carefully review this entire issues and make appropriate policy decisions to insure that excessive Federal intervention into legitimate State and local financing technique is prevented.

Municipalities throughout the country have expressed concern that the new proposed regulations on arbitrage bonds published on May 8 may disrupt municipal financing and could even result in increased local taxes and lower quality of municipal services.

Municipalities expressed these concerns at IRS hearings on July 25.

The Finance Committee will look at several aspects of what is, admittedly, an extremely complex issue.

First, we want to determine whether there is a need for investment limitations on genuine invested sinking funds that are used to repay so-called term bonds. Is there any evidence that a proliferation of invested sinking funds, either for new money issues or for refunding, might actually dry up interest rates to the detriment of all State and local entities? What are the precise differences between invested sinking funds in contrast to debt reserve funds or operating funds?

Second, with respect to advance refundings, the Treasury Department believes that certain legal or underwriting fees should be disregarded for the purpose of computing yield for the arbitrage calculations.

We want to determine whether there have been real abuses which necessitate this change of policy. If there have been abuses, we want to determine whether this is the most appropriate means to remedy the problem.

Third, the Treasury Department has suggested changing the certification procedure which relates to whether there is a reasonable expectation that the bond proceeds will not be invested to such a manner as to result in an arbitrage profit. We want to determine what the rationale for this change is.

Fourth, we will look at the question of advance refundings. Should advance refundings be permitted for normal governmental activities, such as airports? Does sound tax policy dictate different rules for advance refundings of industrial development bonds for nongovernmental activities?

These are some of the most complex issues that have ever faced the Finance Committee.

We are fortunate to have as our first witness this afternoon the Assistant Secretary of the Treasury, Mr. Don Lubick. Mr. Lubick has the respect of all the members of this committee and we look forward to his guidance in developing some reasonable rules and to clear up any misunderstandings as to what the regulations are meant to do, and to provide such rules that will provide such maximum flexibility for State and local financing officials, but at the same time prevent some of the real abuses that Treasury is aware of.

Mr. Secretary, we are very pleased to have you.

Please proceed.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, ACCOMPANIED BY JOHN M. SAMUELS, DEPUTY TO THE LEGISLATIVE COUNSEL, AND BENJAMIN J. COHEN, ATTORNEY, ALL OF DEPARTMENT OF THE TREASURY

Mr. LUBICK. Thank you, Mr. Chairman. Thank you for your invitation to be here. We are very pleased to discuss this matter of recent Treasury regulations in the industrial development bond and arbitrage bond financing areas.

With your permission I would request that my prepared statement be inserted into the record, and I would like to summarize the gist of it.

Senator BENTSEN. That will be done.

Mr. LUBICK. I think I should also state that we share the objectives to which you referred in your opening statement. We indeed are interested in protecing the ability of State and local governments to finance their activities through sound issues of indebtedness. Basically, we are interested in confining our regulatory activity in this area to dealing with the inhibitions which Congress enacted in 1969 with respect to arbitrage activity.

We believe that our recent proposed regulations are legally proper interpretations of section 103, and, moreover, that they reflect sound policy decisions in this area.

We have consulted extensively in the last couple of months with representatives of State and local governments, representatives of their organizations, with experienced bond counsel, who are experts in the field, and we have been working on preparation of revisions and clarifications of the regulations to take into account items which they have raised. We think that in almost all cases much of the distress and much of the confusion with respect to the regulations has been attributable to misreading of the language, at least with respect to our intent. We are hopeful that we will be able to make public very shortly a revised proposed regulation which will allay most of the fears which have been expressed in this area. We believe that, following that notice of proposed rulemaking, we will again be able to receive comments of a technical nature on that, and that within a relatively short time we will be able finally to issue regulations in permanent form in this area and regulations which we hope will be clearly written and understandable by those persons who have to labor in this area.

We do believe that a rollback of the regulations in these areas would be disastrous for State and local governments, and it would be harmful to their ability to finance needed governmental projects.

Senator HASKELL. Excuse me, Mr. Chairman.

I would like to ask the witness what he means by rollbacks.

Mr. LUBICK. The legislation, as I understand it, would serve to——

Senator BENTSEN. He is speaking of this piece of legislation that I have introduced. He is somewhat opposed to my piece of legislation.

Senator HASKELL. Oh? I can't understand why. [General laughter.]

Mr. LUBICK. We have mild opposition, Senator Bentsen.

Senator BENTSEN. It defers the implementation of those regulations until the end of 1979.

Mr. LUBICK. We have been rolling and rolling recently in a number of areas, and we think it is sort of time to flatten out the ground a little. [General laughter.]

We are concerned, with you, that the increased financing costs which would result to State and local governments from vast amounts of indebtedness which might be added to the market and which we might add, would not finance any new governmental ventures and would require higher property taxes. We have received a message that that seems to run counter to popular demands these days.

I would like to start out by giving a brief definition of what we are talking about as arbitrage bonds.

Basically, what we are talking about are municipal bonds which are used to make an investment profit. They are issued to provide a yield which is lower than the return to the State and local government from its investment, which can be attributed to their financial issues and replacements which they make in that area.

Arbitrage profit has two drawbacks. The first is one about which we are naturally concerned, and that is that the cost to the Treasury, the cost to the Federal fist, is considerably more than the arbitrage profit earned by the local government. The tax exemption, the forgone revenues to the United States, are invariably greater than the saving in arbitrage profit to the State and local government. That means that the net loss is shifted to the taxpayers of the country as a whole.

But, more importantly, we are concerned with the financial well-being and the ability of State and local governments to remain viable and independent. I think that we have seen evidence that arbitrage bonds crowd out normal project bonds and normal financing of State and local governments and thereby drive up the cost of municipal borrowing.

It is for these reasons that in 1969 Congress, with the support of the State and local governments, denied tax exemption to arbitrage bonds.

Congress did permit unrestricted investment for temporary periods pending the expenditure of the bond proceeds on the project, and, moreover, it did allow a reasonably required reserve fund, up to 15 percent, and, even higher than the 15 percent, if the issuer established a reasonable requirement for a larger one.

The 15 percent, I should note here, is 15 percent of the original proceeds of the issue of the bond and not 15 percent of the balance of the bonds that are unredeemed and outstanding at any time.

Again, our experience has indicated that 15 percent, in most situations, is a fairly high amount where the reserve fund is required to protect the security of the indebtedness.

Senator BENTSEN. Let me interrupt there.

If they exceed the 15 percent, are they automatically in violation, or do you then go into a judgment area and an area of negotiation?

Mr. LUBICK. The statute says that the issuer must establish that a higher amount is reasonably required.

Senator BENTSEN. The burden is on the issuer.

Mr. LUBICK. So, you are in a judgment area.

Senator BENTSEN. I see.

Mr. LUBICK. Incidentally, we have been working with the Internal Revenue Service in this area to try to establish procedures for expedited review and handling of rulings in this area. So, we are very hopeful that this will not be an undue burden on State and local governments.

Senator HASKELL. Let me interrupt you there, please.

There is something that bothers me.

I understood that the Service had refused to rule on the question of arbitrage. Of course, it is necessary to have rulings on the tax-exempt status of bonds, as a whole, before you can really sell them.

Now, is my understanding correct or incorrect?

Mr. LUBICK. I don't believe that is correct. Senator Haskell.

I am informed by John Samuels, our tax legislative counsel, that the Service has and will rule in this area.

Senator HASKELL. Well, I was informed differently by a very competent municipal bond lawyer in Denver, but he could be wrong—or, Mr. Samuels could be wrong. But I hope he is really sure.

Mr. LUBICK. Senator Haskell, I believe I can assure you in speaking of the future that Mr. Samuels is correct, and we will be glad to discuss with you who is correct as to the past. [General laughter.] Perhaps we are dealing with different areas.

The computer programed invested sinking fund is a relatively new device. We had sinking funds around for a long time. But by and large, the computer programed investment fund that we are talking about these days is about a year or two old and is an ingenious way of circumventing the arbitrage rules which were enacted by the Congress in 1969.

Typically, municipal bonds were issued with a serial maturity. After a certain period, bonds of a given issue would mature and be retired; or, they may have a single terminal date, but a certain portion of them would be called each year after being outstanding for a period of time.

Now, the invested sinking fund changes that practice by leaving the entire amount of an issue outstanding until the ultimate maturity date, and, instead of calling bonds or having a portion of the bonds mature prior to that date, the revenues from the project are put into a sinking fund and invested, usually secured by U.S. bonds, and held until the ultimate maturity date, in which case bonds are then paid off.

The result is that during this extended period, during which the sinking fund is built up and invested, you have an arbitrage profit earned by the State and local government. Its bonds are outstanding, for example, at 6 or 5.5 percent and the sinking fund is building up and earning interest at 7.5 or 8 percent.

It is to the advantage of the State and local government to keep the bonds outstanding as long as possible, until the ultimate maturity, because it can make this arbitrage profit.

Now, in addition to extending the maturity of bonds which would normally be retired serially, the invested sinking fund encourages advance refundings with a sinking fund device. I would like to turn to that in a minute.

Our estimates indicate that, if unchecked, use of the investment sinking fund would produce over the course of time a nearly 50-percent increase in the volume of municipal indebtedness outstanding, without regard to advance refunding, just by virtue of the extension of maturities of bonds which would have been called or would have serial redemption dates.

The result would be an increase in volume of close to 50 percent.

Now, the regulations which we proposed made clear that arbitrage by this device is bad.

I might simply refer to a few quotations from the Daily Bond Buyer of May 4 of the reaction of the financial community to the proposed regulation.

Thomas S. Ambrosio, senior vice president of American Securities Corp., termed the invested sinker technique "working in gimmickry," and said, "I almost welcomed the IRS decision at that point"—and I regard that as a firm embrace, when someone says he almost welcomes us.

> We should be marketing bonds as opposed to giving them away. The impact on the market of the ruling will be helpful for the overall market because of supply and demand.

Mr. Noonan, vice president of Kidder Peabody, said:

> There are a lot of deals which are marginally feasible because of the invested sinker technique. The regulations won't affect Kidder Peabody because all of our issues in progress now qualify.

David R. Rochet, senior vice president of Donaldson, Lufkin, and Gennerette Securities Corp.:

> I am in favor of eliminating those things. It just put a lot of bonds in the market that were not in the public interest, bonds that just took advantage of arbitrage. The invested sinking fund technique disrupted the market and made it more costly for legitimate borrowers to borrow.

Now, I mentioned briefly that arbitrage has become very popular in combination with advance refunding techniques. The advance refunding technique is one where bonds are issued currently for the purpose of establishing proceeds which will be used ultimately—not immediately, but 5, 10, or 15 years down the road—to pay off the first issue. Again, here we have a doubling of the amount, the dollar amount, of bonds that is outstanding, and the potential arbitrage profit through the use of the invested sinking fund has made it very attractive to engage in this advance refunding technique so that we find, again, a great increase, a great proliferation in the amount of indebtedness with no additional revenues going to fund State and local projects.

Moreover, in the advance refunding case, we have bonds which are not only tax exempt, but because of the fact that they are secured by investments in U.S. Government securities, they are guaranteed by the United States. A relatively short time ago you decided it was not appropriate, in the case of New York City, to have Federal guarantee of municipal debt. But that, in effect, is a situation that is encouraged by the combination of arbitrage and advance refunding.

We have tried to be very careful to avoid interference with conventional financing practices.

For example, many municipalities have operating funds. There was some misunderstanding that these operating funds might be affected by the arbitrage regulations. We have issued, yesterday, a revenue ruling which will clarify the doubts in this area. This revenue ruling was produced by us after extensive consultation with State and local governments, after having been reviewed with a fine-tooth comb by counsel selected by the organizations of State and local governments, and by other experts in the field with whom we have consulted.

I would like to point out again that if an issue is affected by the arbitrage regulations, that does not mean that the issue cannot proceed. It simply means that there is a limitation on the amount of arbitrage profit that can be made from reinvesting in U.S. Government securities.

Senator BENTSEN. What happens to the excess?

Mr. LUBICK. The U.S. Treasury has a special series of bonds which will be issued at a rate to eliminate the arbitrage profit.

Senator BENTSEN. They have to use the excess and invest in those specific bonds, is that what you are saying?

They have to use the excess that would be termed arbitrage to invest in those specific securities.

Mr. LUBICK. Well, the amount that would produce that excess—that is right, and we avoid the excess that way. That is correct.

Now, I may say with respect to these conventional financing techniques that we stand ready to meet with any and all municipal governments and their counsel who believe they still have problems. If they are legitimate problems that we have not foreseen, we stand ready to meet with them. There is considerable flexibility that is granted by Congress to effectuate the purpose of the arbitrage statute, and we have been working very closely and will continue to work closely with representatives of the State and local governments.

We had an extensive meeting this morning with Mayor Vann of Birmingham, who is here. We are investigating his situation. We think there is a possibility that, when we see all the facts, he will not be affected in the city of Birmingham by the regulations, or at least not as he thought he would. There are escape valves, if he is affected, that can be handled. We are looking forward to cooperating with State and local governments which have legitimate concerns and historic practices that do not involve the device with which we are concerned.

I would like to turn very briefly, if I may, to the question of advance refundings of industrial development bonds because your legislation, Senator Bentsen, also dealt with our November regulations.

Senator BENTSEN. I think there is going to be a vote on the floor, probably in about 30 minutes, on that issue.

Mr. LUBICK. I hope you will vote the right way, Senator Bentsen. [General laughter.]

I think that you will find, generally speaking, that the State and local governments find the proliferation of industrial development bonds, which, essentially, are the issuance of private indebtedness under the cloak of the municipal tax exemption, to be an undesirable thing from their point of view. Again, the proliferation of industrial development bonds has an adverse effect on municipal financing.

I recall very interesting evidence of the significance of this. When our regulations were issued last November, they were issued at a time when interest rates were climbing. General market interest rates were on the rise.

The day our regulations came out, the rate of interest on municipal bonds declined, contrary to the general trend of the market, indicating the beneficial effect on the cost of borrowing for State and local governments by preventing a huge volume, close to $1 billion, of industrial development bonds coming on to the market. These were advance refundings of bonds which were issued before 1968, which the persons involved were trying to refund, and thereby, it seems to us fairly clear, avoid the prohibition which Congress had enacted in 1968.

In 1968, Congress said no new industrial development bond financing and the refunding technique, by posing as an amendment to an existing issue, was extending the time for which these grandfathered bonds could remain outstanding.

You mentioned one other item, Mr. Chairman, in your introduction and that dealt with the distinction between governmental activities and nongovernmental activities. That is related to the industrial development bond classification.

Unfortunately, the statute defining industrial development bonds lumps together a lot of activities—airports, stadia, as well as pollution bonds, which are generally issued for the benefit of private corporations.

W were unable to make a distinction under the statute between these various functions because they were all put together. So, we have been working ourselves and closely with representatives of various State and local governments to come up with a legislative proposal to redefine in this area what are industrial development bonds. Those that represent the performance by the State and local government of genuine governmental functions we would think should not be subject to the same rules.

We are going to release our draft fairly soon. We suggest that a sound principle would be that in a situation where the State and local government is genuinely the owner of the item which is being financed by the issue, the industrial bond rules ought not to apply. In those situations where the rules are simply a cloak for private industry being the owner, then we think that it is inappropriate to have private industry, selected private industry, have the benefit of tax exemption, which should be reserved for municipalities and State governments.

In closing, I would simply like to say that our regulations, both in November and in May, were in response to pressures that we received from state and local governments and from responsible underwriters who were in fear of a collapse of the municipal market. If we had not acted, I think the result might have been an enormous volume of sinking fund bonds. The total amount of municipal bonds today is $250 billion. From a short run perspective, it would be highly advantageous, it least initially, to refund the great majority of these bonds. If only 20 percent are refunded, this would amount to a volume of $50 billion. Fifty billion dollars is more than the total volume for the entire year of 1977. If anything approaching that $50 billion of sinking fund bonds were sold, the effect on the market could be catastrophic. Borrowing costs, local taxes would go up. Communities that have financial problems and need access to the market the most would be unable to sell their bonds. Thousands of innocent people who have put their savings into tax exempt municipal bonds would suffer substantial losses because as interest rates rise, the principal values of those bonds that were issued earlier is going to decline.

The regulations which we have proposed are not aimed at customary financial practices. As I indicated, we are willing to work to solve any problems that arise.

On the other hand, Mr. Chairman, with all due respect, we think that S. 3370 is one of the worst possible ways of attacking these problems.

Senator BENTSEN. Mr. Secretary, it got your attention and now we are trying to work out some solutions to it. That's one of the major reasons for it.

Let me ask you about the ruling in refunding situations, which indicates that you do not think certain underwriting costs and legal costs should be used as a part of the computation in determining yield for arbitrage purposes. Now surely there are certain underwriting costs and legal costs that are legitimate and proper and affect true yield, or so it seems to me.

Would you elaborate on that?

Mr. LUBICK. Yes.

I would agree that underwriting and legal costs are legitimate.

Senator BENTSEN. To determine yield, in effect.

Mr. LUBICK. They do affect the interest cost to the municipality, to the issuer. It is a cost of putting out the issue and therefore it is part of their cost, and under any method of financing, whether corporate or governmental, it is a cost of the issue.

That is a different question, Senator Bentsen, from the yield to the holder of the bond, the yield to the investor.

Senator BENTSEN. Oh, yes.

Mr. LUBICK. The statute, in measuring arbitrage, is talking in terms of yield which we think is quite different.

What I would like to say is that basically the cost of putting out an issue, the legal costs and the underwriting costs, in the case of new issues have to be absorbed by the issuer. There is no way around that. That is the situation.

The financing of these legal costs and the underwriting costs out of arbitrage profits or arbitrage differentials is something that has been limited only to advance refundings. That opportunity is not available to new issues. Therefore, we have seen a number of cases where the costs exceed the saving to the municipality.

If you have a situation where an issue is put out at 6 percent and the next day the interest cost goes down to 5.998 percent, it will pay the municipality to refund the issue on an advance refunding basis at 5.998 percent as long as it can finance the legal and underwriting costs out of the arbitrage differential.

The result is that the new issue situation, the municipality has some constraints on it. It has to take into account as part of the cost of borrowing the legitimate expenses of legal and underwriting fees.

You do not have any such restraint in the case of advance refundings if you permit all of those expenses to be charged to the United States because they become a wash as far as the municipality is concerned. There is evidence that this has increased the propensity of State and local governments to put out these issues. It has increased the propensity of some counsel and some underwriters to charge fees higher than what might mormally be regarded as reasonable. I have a very high threshold as to what is reasonable in this area, but sometimes even that has been exceeded.

I think that basically what you are doing to the extent that you are is you are cutting losses, reducing interest expense of municipalities through permiting an arbitrage profit to pay for that. It is the same as the situation where you are putting the profit in the hands of the issuer. This is because whether you have a reduction in liabilities or an increase in assets, you have a profit either way. I think basically the advance refundings ought not to be on a better basis than the new issues.

Senator BENTSEN. Thank you.

Your answer obviously used up my 5 minutes.

So, Senator Haskell, would you like to question the witness?

Senator HASKELL. Thank you. I will ask one question.

One of the things that concerned me, Mr. Secretary, is the fact that this statute was enacted in 1969, and it is my understanding that the regulations are still in proposed form.

Is that understanding correct?

Mr. LUBICK. Yes.

That concerns us, too, Senator Haskell. As I indicated, we are working very hard to see if we can have final permanent regulations in this area. We are working on revisions and clarifications. You are perfectly right. We should do something about that.

Senator HASKELL. One of the reasons this concerns me is I don't see how anybody can test the validity of a proposed regulation. And yet, the industry has been operating for basically almost a decade, under a proposed regulation.

I don't see how a private party or a municipality could test the validity of a proposed regulation. It puts the industry—in this case we are talking about municipalities and related persons—in a terrible position.

Would you concur with that?

Mr. LUBICK. No, Senator Haskell. I don't think that's quite right.

We have indicated that persons may rely upon the proposed regulations for their financing purposes.

Senator HASKELL. Supposed they think you are legislating by regulations. How are they going to test that?

Mr. LUBICK. The same way they would test it if we had a final regulalation. Exactly the same way.

Senator HASKELL. Well, I would like to hear whether or not others agree with you on this particular subject.

Mr. LUBICK. I might point out that if we have final regulations, I think it will require a hardy soul to put out an issue——

Senator HASKELL. I agree.

Mr. LUBICK. [continuing]. Because a lot of people aren't going to want to buy an issue.

Senator HASKELL. I agree with that, and this is one of the reasons why I have asked you about ruling policy.

There is just one other point, and then I will turn the questioning back to the chairman.

I understand that the statute says that reinvestment of the proceeds cannot be in a yield which is "materially higher" than the bond issue refunded.

It is also my understanding that the Treasury essentially prohibits reinvestment if the interest is any higher. Am I correct in that?

Mr. LUBICK. Senator Haskell, your statement of the soon-to-be-old rule is correct. However, the revised regulation which is to be proposed is changing that, except with respect to advanced—well, let me ask Mr. Samuels to answer that.

Senator HASKELL. Well, don't bother, if it is going to be changed, that is sufficient.

I think that Senator Bentsen was quite right when he said he got the Treasury Department's attention on this matter.

For myself, this is a very technical subject, and I don't want to go into it in this hearing. I am not sure that I fully understand all of its ramifications.

But I think it is vital that you do sit down with the affected parties and come to some final regulations, meeting their legitimate problems. I am sure that some of the points they raise may not be fully legitimate. But I am sure that some of their points are fully legitimate.

I would like to congratulate my colleague. I don't know whether I will vote for his bill or not; I have not decided. But I would like to congratulate him for bringing this to a head, because I think it is a very unfortunate situation.

Mr. LUBICK. I would like to assure the chairman that he can have our attention at any time, without the necessity of recourse to such a drastic remedy.

[General laughter.]

Senator BENTSEN. Let me say to my colleague—and I thank him very much—that whether or not I will vote for my bill will depend on what Treasury does in the meantime.

Senator HASKELL. That is the situation I am in.

Senator BENTSEN. Mr. Secretary, it is my understanding that Treasury also is talking about changing the means of certification with the idea of getting to the point of is there reasonable expectation that the bond proceeds will not be invested in a manner in which arbitrage profits will be incurred.

If that is so, why, and what do you have in mind?

Mr. LUBICK. Up until now, Mr. Chairman, if the issuer certified that the bond was not an arbitrage bond, that was final and conclusive, and no one could go behind it.

What we are suggesting is that the issuer's representation with respect to the facts, what its intention has to do with the proceeds of the bond and the like, is still going to be conclusive. But, as to the legal issue, as to legal conclusions from the application of the law to the facts, the normal rules which apply with respect to other types of municipal financing will be applicable. They will have to rely upon counsel or go through the ruling process to determine the interpretation of the law. That is a procedure that seems to have worked very satisfactorily.

As a present member of the legal profession, that is what we are paid to do—to ascertain the law. We hope that our regulations will be sufficiently precise to enable that. But we will put some responsibility on someone with respect to the question as to whether we have an arbitrage bond or not—on the legal question, not with respect to factual questions.

Senator BENTSEN. Does this mean that all of this could be consummated prior to issuance so that you do not have a purchaser out there in jeopardy as to the classification?

Mr. LUBICK. Basically, if there is a legal opinion and the legal opinion is erroneous, the issue would not be tax exempt, and that would mean that there would be——

Senator BENTSEN. What I am asking is, is there some hazard to a purchaser under this approach? Isn't there? Does he take more of a risk?

Mr. LUBICK. I would say that essentially there is not, Senator Bentsen. There is more hazard to the counsel. I think he is going to have to not go quite up to the cliff.

Senator BENTSEN. Well, if there is not more hazard to the purchaser, then there would have to be an awfully solvent counsel, wouldn't there?

Mr. LUBICK. Or solvent insurance carriers.

[General laughter.]

Mr. SAMUELS. Mr. Chairman, I would like to make one point.

Municipal bonds are sold regularly on the basis of unqualified opinions of counsel. They face many vexing questions that have nothing to do with arbitrage. There is no certification procedure which essentially lets them issue themselves a ruling.

Senator BENTSEN. Well, I am not that familiar with the procedures on this, but now, on the certification, aren't there certain criteria or guidelines which they have to follow, and if they have followed all of those they are in reasonably good shape insofar as it qualifying?

Mr. SAMUELS. That is correct. Indeed, we think they are in too good shape. That is what we are saying. At least some counsel take the position that if they follow those guidelines, that certificate is conclusively binding upon the Internal Revenue Service, and if, in fact, that bond was an arbitrage bond, nonetheless that certificate, notwithstanding subsequent events, is controlling and the interest on that bond will remain tax exempt.

That is not the statutory scheme. It is not the sanction Congress provided for an arbitrage bond. We think it is only appropriate for there to be certification as to future factual events.

The issuer says, "I intend to build a school with this money," so we will take his word for that. That is a reasonable statement and if the facts change, the Service is bound by that and the bondholder is protected.

But, alternatively, if there is a scheme laid out in this certificate and then the certificate also says that these are not arbitrage bonds—and that is a legal conclusion—we don't want the Internal Revenue Service to be bound by the legal characterization of facts. We don't think that is appropriate.

We think this certificate procedure is one of the reasons we have had this series of regulations that both State and local governments and the Treasury Department would like to see come to an end.

Senator HASKELL. Mr. Chairman, may I interrupt at this point?

Senator BENTSEN. Please do.

Senator HASKELL. Are you saying, sir, that assuming that in the application for the ruling the facts are accurately stated, then the Treasury is or is not bound?

Mr. SAMUELS. Indeed, Senator, the issuer does not even have to get a ruling. We are bound by the statement of facts in the certificate. It does not have to come to Washington at all. If the issuer states the facts as to how it expects to use the bond proceeds, then the Internal Revenue Service accepts those facts.

Senator HASKELL. What is this certificate? Is it an application for a ruling?

Mr. SAMUELS. No; it is not. It is something that was dreamed up by the original draftsmen of the regulations.

Whether or not a bond is an arbitrage bond depends upon the issuer's reasonable expectations into the future as to what he is going to do with the bond proceeds. The bond counsel, the issuer, and the market essentially said, "How do we know what this issuer is going to do in the future. We have to buy the bonds now. We want some assurance now that these bond proceeds won't be used in a manner to make them arbitrage bonds."

So, the draftsmen of the regulations said, "Well, we will let the issuer tell us how he is going to use the money and we will accept the factual statements as to how that money is going to be spent."

But we believe that the draftsmen of the original regulations went too far, or at least bond counsel have interpreted the regulations to permit the issuer to certify not only facts, but to certify that this bond is not an arbitrage bond.

In our new regulations, we are going to exempt certain small issues from this requirement and allow them to continue to certify legal conclusions, if you will. So, they won't have to go to the trouble of having their counsel search every nook and cranny of the tax law and incur that expense.

But, with respect to most issues, we think bond counsel are the ones who should be responsible for making sure that these bonds are not arbitrage bonds.

Now, I don't think the innocent bondholder will be the one who is hurt. He will be the one you hear about. But the securities laws of this country are such that if that bond counsel's opinion is unreasonable and he gives it an unqualified opinion that these bonds are tax free, and they are not, the bondholder will not have any trouble collecting his money, with interest.

I think that the concern is that the risk has shifted. This is a risk that exists in municipal finance on questions that are equally vexing, equally complicated, not just arbitrage.

Senator HASKELL. All I want to be sure is that the Internal Revenue Service does not change its mind at some future time as to whether the stated facts do or do not qualify the bond as arbitrage.

I don't want the Internal Revenue Service to be able to change its legal conclusion.

Mr. LUBICK. That is a determination which is made as of the issuance date. The fact that the issues goes on and does something different from what it proposed originally does not change the status of the bond. This determination is made ab initio.

Senator HASKELL. Thank you.

Thank you, Mr. Chairman.

Senator BENTSEN. I have no further questions.

Thank you, gentlemen, for your testimony. We are very pleased to have had you.

[The prepared statement of Mr. Lubick follows:]

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)

Mr. Chairman and members of the committee, we welcome the opportunity to present the Treasury Department's views on S. 3370. In broad terms, this bill would roll back the Treasury's recent regulations concerning arbitrage, sinking funds, and advance refundings. It would also put a freeze on further regulations for approximately a year and a half.

We are strongly opposed to S. 3370. The bill would result in substantial federal revenue losses and would seriously and adversely affect the market for tax-exempt secruities.

ARBITRAGE

Generally, an "arbitrage bond" is a municipal bond that is used to make an investment profit. The yield on a tax-exempt municipal bond is ordinarily lower than the yield on Treasury notes, certificates of deposit, and other high-grade taxable investments. Thus, for example, a substantial profit can be made by selling municipal bonds at six percent and investing the proceeds in Treasury notes at 8½ percent. Bonds use to secure this profit are called "arbitrage bonds."

A State or local government can earn a substantial profit from arbitrage. However, arbitrage has two drawbacks that more than offset this profit. First, the cost to the Treasury is considerably more than the profit earned by the State or local government. Thus, arbitrage results in a net loss to the taxpayers of the country as a whole. Second, arbitrage damages the market for municipal bonds. Arbitrage bonds tend to crowd out bonds that are sold to finance roads, schools, and other traditional projects. Thus, in the long run, arbitrage tends to drive up the cost of municipal borrowing, and therefore is self-defeating and contrary to the interests of State and local governments. For these reasons, in 1969, Congress delegated broad authority to the Treasury to keep arbitrage bonds off the market. To that end, the Treasury has written extensive regul ions. However, these regulations have not been completely successful. A series of devices has been invented to circumvent the arbitrage regulations, the most recent being the invested sinking fund (sometimes called the "Bullet" or the "Nashville Goose").

INVESTED SINKING FUNDS

Typically, municipal bonds have serial maturities. For example, if a city sells $10 million of 20-year school bonds, the city may use property taxes to pay a portion of the principal off each year. Thus, for the protection of the bondholders, the bonds will be paid off gradually over 20 years, and the $10 million principal amount will not come due all at once. However, if the city employs an invested sinking fund, it will not pay any principal off until the bonds come due in 20 years. Instead, the city will periodically pay property taxes into a sinking fund. Amounts held in the sinking fund will be invested in Treasury notes or high-grade taxable investments, enabling the city to make a substantial investment profit.

The invested sinking fund was devised as a way around Treasury's arbitrage regulations. In the short run, certain State and local governments were able to gain a financial advantage from invested sinking funds. However, in the long run, invested sinking funds (like other forms of arbitrage) are a burden on taxpayers and a threat to the market for municipal bonds. In particular, invested sinking funds damaged the tax-exempt market in two ways. First, bonds that used this device were left outstanding longer because they were not retired serially. Second, many refunding issues were motivated chiefly by the profit that could be earned from an invested sinking fund; these issues would not have been sold if that profit had not been available. The invested sinking fund—if unchecked—could have resulted in nearly a 50-percent increase in the amount of tax-exempt bonds outstanding without taking account of advance refundings. The estimated annual loss in Federal revenue could ultimately have reached $3 to 3.5 billion at 1979 levels.

It is also important to note that the elimination of the invested sinking fund was regarded favorably by a substantial segment of the concerned financial community.

ADVANCE REFUNDINGS

The remainder of the regulations apply primarily to advance refunding. An advance refunding is an unusual type of financial transaction, almost unique to municipal finance. It is also a highly sophisticated type of transaction, and generally cannot be done without the aid of computers.

An ordinarily refunding is a relatively simple transaction. It enables an issuer to substitute new bonds for outstanding bonds. Generally, the substitution is made because the outstanding bonds were sold on unfavorable terms. For example, the interest rate on the old bonds may be too high, or the indenture for the old bonds may contain unduly restricted covenants. In an ordinary refunding, a state or local government simply sells new bonds, and uses the proceeds to call in its outstanding bonds.

By contrast, in an advance refunding, both sets of bonds remain outstanding. For example, assume that a sanitation district has $10 million of bonds outstanding. In an advance refunding, the district will typically sell an additional $11 or $12 million of refunding bonds. However, it will not call its outstanding bonds immediately. These bonds will remain outstanding for perhaps 5, 10, or even 20 years. Until the sanitation district calls in its old bonds, the proceeds of the new bonds will be kept in an escrow fund. The escrow fund will be invested in United States Treasury obligations. These obligations will be selected with the aid of computer so that the casa flow earned by the escrow fund is just sufficient to pay debt service on the old bonds.

The serious questions of tax policy raised by arbitrage bonds are compounded in the context of advance refundings. First, they double the amount of tax exempt bonds outstanding for any project. As a result, they tend to increase borrowing costs and impair the ability of hard-pressed state and local governments to provide essential services.

Second, the holders of the old bonds get a double benefit. In addition to being tax-exempt, these bonds are effectively guaranteed by the United States. Thus, the old bonds are superior both to obligations of the United States Treasury and to conventional municipal obligations. Recently, the Congress rejected this double benefit—both a tax exemption and a federal guarantee—in the case of the New York City Financial Assistance Act. The Congress determined that it was inappropriate to provide New York City with this double benefit, even in connection with a program necessary to assure the City's financial survival. In the case of a typical advance refuning, where much less than financial survival is at stake, this double benefit is still less appropriate.

And third, advance refundings have been the principal cause of the difficulties that we have had with the arbitrage regulations. As stated earlier, a continuing series of devices has been invented to circumvent the arbitrage regulations. For a variety of reasons, these devices have been used almost exclusively in connection with advance refundings. Thus, advance refundings have been the principal cause of frequent changes in the arbitrage regulations. These frequent changes have tended to disrupt the tax exempt market. They have been bad for the Treasury, bad for state and local governments, and generally bad for all concerned.

IDB'S

Advance refundings of industrial development bonds (or IDB's) are particularly questionable. Generally, IDB's are governmental in form, but are issued to raise capital for private business enterprise. Most frequently, the proceeds of an issue of IDB's are used to build a facility which is "leased" for its useful life to an industrial user at a rental exactly sufficient to pay debt service on the bonds; generally the government unit is not liable on the bonds and the holders must look solely to the credit of the industrial user. The use of the tax-exempt market for such essentially private purposes places a burden on that market and drives up the cost of municipal borrowings for conventional governmental purposes. Therefore, on November 4, 1977, the Treasury announced regulations that generally prevent advance refundings of industrial development bonds.

However, the Treasury recognized that these regulations might, in certain cases, cause hardship to state and local governments. As a result, the Treasury announced that it would support legislation to alleviate these hardships. In the past nine months, the Treasury has worked closely with affected governmental officials to develop appropriate legislation. Our work on this legislation is now substantially complete, and we expect that it will be made public shortly.

ADMINISTRATIVE COSTS

In the case of any advance refunding, the existing regulations permit an issuer to earn enough arbitrage to cover most or all of the administrative costs. We believe that this is bad policy. While some advance refundings may have a legitimate financial purpose, we believe that they should pay their own way.

The ability to earn back administrative costs has led many issuers to pay inflated and excessive fees to lawyers, accountants, underwriters, and others. However, this abuse is not the only reason for requiring issuers to pay the administrative costs of advance refundings. The ability of issuers to recover administrative costs has led to many refundings that are economically unsound. For example, assume that the administrative costs of an advance refunding are $3 million, and the gross debt service savings are $2 million. Economically, the transaction does not make sense. There is no good reason to spend $3 million in order to save $2 million. However, under the existing regulations, this transaction would probably be dnoe. The issuer would save nearly $2 million, and underwriters, lawyers, and financial advisors would earn $3 million at the expense of the Federal Treasury. The public cannot benefit from a transaction in which $3 million is spent to save $2 million. Only the recipients of the $3 million—the underwriters, the lawyers, and the financial advisors—can benefit.

Further, the treatment of expenses in the case of advance refundings discriminates against new money issues in two ways. First, issuers generally cannot recover their administrative costs in the case of new money issues. Recovery of such costs is generally possible only in connection with advance refundings. And second, advance refundings occupy a considerable share of the market, crowding out new money issues needed for schools, roads, water systems, and other essential projects.

CERTIFICATION

The last aspect of the new regulations we would like to address is certification. Under existing regulations, issues are able to "certify" their bonds conclusively. As a result, they are able to act as the sole judge of whether their bonds comply with Internal Revenue laws. This ability has been a major cause of the continuing series of devices that have been invented to circumvent the arbitrage regulations. It permits bond lawyers to interpret the regulations in a highly aggressive manner and has severely handicapped the IRS in its efforts to protect the tax-exempt market.

Therefore, the certification is revised under the new regulations. These revisions are designed to make bond lawyers stand behind the opinions they give. After September 1, bond lawyers will no longer be able to give irresponsible opinions and hide behind a conclusive certification. The revised certification will enable the IRS to enforce the regulations effectively, and at the same time protect issuers acting in good faith.

CUSTOMARY FINANCIAL PRACTICES

We wish to emphasize particularly that the new amendments are not intended to interfere with customary financial practices. They are aimed only at sophisticated devices to circumvent the arbitrage regulations. Some state and local governments have expressed the concern that the regulations will disrupt customary financial practices. These concerns are absolutely sincere. To a large extent, however, they are unjustified. They reflect advice given by certain bond counsel who insist—for reasons of their own—on reading the regulations is a way that was never intended. In order to allay these concerns, the Treasury issued a press release yesterday that contained two revenue rulings to clarify the regulations.

There may be ambiquities and technical defects in the proposed regulations. Municipal finance is a complicated area, and our regulations are not always perfect. However, we believe that any problems can be solved by appropriate amendments to the regulations. Further, we believe that S. 3370 is a drastic over-reaction to these problems.

In May of this year, before the sinking fund rules became effective, the volume of sinking fund bonds was large and growing rapidly. If the sinking fund rules are repealed, we would anticipate an enormous volume of sinking fund bonds. The total amount of municipal bonds now outstanding is approximately $250 billion. From a short-run perspective, it would be highly advantageous, at least initially, to refund the great majority of these bonds. If only 20 percent are refunded, this would amount to a volume of $50 billion. Fifty billion dollars is more than the total volume for the entire year of 1977. If anything approaching $50 billion of sinking fund bonds were sold, the effect on the market could be catastrophic. Borrowing costs, and hence local taxes, would go up. Communities that have financial problems—and these are the communities that need access to the market most—might be unable to sell their bonds. Thousands of innocent people who have put their savings into tax exempt municipal bonds could suffer substantial losses. The strain on the market would be very considerable indeed.

In conclusion, the new regulations are aimed at sophisticated arbitrage devices put together by resourceful and ingenious financial advisors and computer experts. They are not aimed at customary financial practices. To the extent that they are problems with the regulations, we are absolutely willing to work out whatever changes are necessary. In this connection, we have been consulting frequently with representatives of state and local governments, and will continue to do so.

On the other hand, S. 3370 would be the worst possible way to attack these problems. It would turn the municipal market into a playground for bond lawyers and computer experts, to the vast detriment of state and local governments, thousands of innocent bondholders, and taxpayers throughout our country.

Senator BENTSEN. Our next witness will be Mr. Carl L. White, finance director, city of San Antonio, Tex. He will be appearing on behalf of the Municipal Finance Officers Association.

Mr. White, welcome.

For the record, would you please introduce your associate.

STATEMENT OF CARL L. WHITE, FINANCE DIRECTOR OF SAN ANTONIO, TEX., ON BEHALF OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION, ACCOMPANIED BY ROBERT W. DOTY, GENERAL COUNSEL, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. WHITE. Thank you, Mr. Chairman.

My name is Carl L. White. I am finance director of the city of San Antonio, Tex.

I am here today representing the Municipal Finance Officers Association, a professional association of over 8,000 State and local governmental finance officials.

This statement also is given on behalf of the National Association of Counties.

I am accompanied by Mr. Robert W. Doty, MFOA's general counsel.

We appreciate the opportunity to appear before you and give our views on S. 3370 and related matters concerning regulation of State and local government finance transactions by the U.S. Treasury Department.

I request that my written comments be inserted in the record.

Senator BENTSEN. Without objection, it is so ordered.

Mr. WHITE. Thank you, sir.

The issue which you are reviewing is one which has generated unprecedented controversy within the municipal bond market during the past 2 years. Too often, the Treasury Department has sought to regulate valid matters, but has overstepped its authority and has far surpassed the degree of regulation which is necessary in order for it to remedy the problems which it seeks to solve.

The reactions of our members finally gave rise to a series of resolutions and a policy statement which were adopted at the MFOA Annual Conference in Houston this past May. Copies of these resolutions and the policy statement are attached to my written comments.

Following our conference, the MFOA General Counsel prepared a memorandum concerning consultation with the U.S. Treasury Department. The whole issue of the inadequacy of consultation which had occurred prior to that time was summarized in that memorandum.

Further, the memorandum lists those problem areas where the Treasury's regulations and related regulatory actions have been viewed by State and local government officials as excessive.

A copy of the relevant portions of this memorandum is attached to my written statement.

Following the completion of our General Counsel's memorandum, the representatives of MFOA and the other public interest groups representing State and local governments opened a dialog with the Treasury Department concerning the consultative problems. The Department has been receptive to that initiative and has held a large number of meetings with MFOA's Washington staff since that time.

This series of meetings has been arduous and, at many times, frustrating both for State and local representatives and Treasury Department officials.

But slowly a number of matters have been worked out. I must add that the active interest of Senator Bentsen, Senator Haskell, and other distinguished members of this committee has been most helpful, particularly within the last few weeks. At the time that S. 3370 was introduced, the regulations of the Treasury were most unsatisfactory to us, although we were hopeful of obtaining eventual remedial action.

Some remedial action now has been obtained. It consists of the following.

First, Revenue Ruling 78–302, issued in July 1978, while causing some difficulties, seeks to clarify that investment funds, unrelated to bond issues, maintained by State and local governments are not "invested sinking funds" within the Department's May 3, 1978, invested sinking fund regulations.

Second, a new revenue ruling issued this week to clarify that funds maintained by State and local governments for the purpose of securing bond issues or otherwise to improve their credit likewise are not invested sinking funds. This clarifies questions which were posed by a portion of the earlier revenue ruling.

Third, establishment of an arrangement by the Treasury Department whereby State and local governments will receive expedited treatment on revenue ruling requests under the arbitrage regulations.

Fourth, public expression of full Treasury Department and administration support for specific statutory language to correct the overreaching of the December 1, 1977, regulations, prohibiting advanced refundings of various public purpose issues, among other types of offerings.

Fifth, continuing consultation regarding problems raised by the May 3 invested sinking fund regulations. These problems include the treatment of taxes and revenues as bond proceeds, very costly restrictions on the arbitrage certification process, the exclusion of administrative costs from yield calculations, thus increasing the effective cost of issuing of bonds of States and their political subdivisions and the unreasonably short temporary period allowed for the investment of funds accumulated in a debt service fund.

If you will permit me to digress just a moment here, the city of San Antonio would lose approximately $2 million—that is what the cost to the city of San Antonio would be if this temporary short period of time is not extended beyond the 13-month period of time.

Sixth is continuing consultation on other matters.

It is unfortunate that matters had to reach their present stage. MFOA believes that adequate Treasury consultation in the beginning would have avoided most of the problems. We trust that future consultation will be directed to this end, and based upon our most recent experiences, are hopeful that this will be the case.

With the actions now under consideration, it is evident that section 103, and particularly the regulations under it, are developing into a Federal law of municipal corporations. State and local governments are being told how to conduct their financial affairs. There is an erosion of the ability to issue debt in a flexible way, which has been an essential factor in State and local independence under our constitutional system.

The structure of governmental entities is to be regulated under "on behalf of" regulations reported in the press to be under consideration.

Regardless of how "workable" any of these regulations may be, in the past, most of such matters were thought to be matters for State and local, not Federal, regulation.

It further must be considered that few, if any, persons with State and local government experience are on the staffs of the Treasury or the Internal Revenue Service working on these matters or working on other questions of importance to State and local governments, such as attempts to regulate our pension plans.

And Treasury has a direct conflict of interest in issuing its arbitrage regulations. By limiting yields, the Department forces States and localities to purchase U.S. Goverement securities at rates significantly below market rates. Several billions of dollars of Federal securities have been sold in this manner.

Considering all these factors, it is thus a matter of increasing importance that there be much more sensitivity at the Treasury to the consequences of its actions than there has been in the past. The Department now has expressed a willingness to listen, and we look forward to the continuation of increased cooperation.

As a result of the Department's recent actions and the continuing consultation, it appears at this time that the Treasury's regulations likely are to be soon in a structure within which State and local governments may function, although we do not intend to imply that this means that the regulations will not impose significant undue costs or restrictions upon State or local governments in the performance of their normal operations.

The Department agrees with us that it has made mistakes in the phrasing and promulgation of its regulations, and has shown some willingness to correct those situations which have been brought to its attention to date.

We must see future actions to amend the invested sinking fund regulations before we will be completely satisfied. Treasury has told us that it will make some of these amendments.

This leads me to a second consideration of our members. Once it is established that the Treasury's regulations provide a framework within which State and local governments can function—and, to a certain extent, this depends upon future action—we must then, lest we be misunderstood, express our concern about the abuse of arbitrage in the municipal securities market.

Arbitrage is a technique whereby issuers of tax exempt obligations may invest at taxable rates the funds which they receive in connection with those transactions. If a sufficient number of arbitrage transactions occur, tax exempt rates would approach taxable rates. This would mean extremely excessive costs for the financing of public projects and the carrying out of other governmental responsibilities. It would pose one of the most significant threats to the tax exemption which we have yet encountered.

Senator BENTSEN. Mr. White, we will take your entire statement in the record. Because of the other witnesses we have to limit the presentations.

Mr. WHITE. Thank you, Mr. Chairman.

Senator BENTSEN. Senator Haskell.

Senator HASKELL. I have no questions, thank you.

I am very pleased to hear Mr. White say that he has been having discussions with the Treasury Department.

Mr. WHITE. MFOA has had a number of meetings with the Treasury Department in the last few months. Yes, sir.

Senator BENTSEN. Mr. White, yesterday the IRS issued two new rulings—78-348 and 78-349. After you have had an opportunity to examine those rulings, I would appreciate your writing us your comments on them so that we can include them in the record.[1]

Mr. WHITE. I certainly shall do that.

Senator BENTSEN. Senator Curtis.

Senator CURTIS. No questions, Mr. Chairman, thank you. I was not able to be present in time to hear the testimony.

Senator BENTSEN. Well, your testimony is helpful. I have been scanning ahead on some of it as you spoke. I, too, share with Senator Haskell his pleasure in hearing that we are beginning to make some headway in working out some of these problems with Treasury. We will continue to work with you in trying to reach that kind of accommodation where we can try to rule out the true abuses and yet not impinge on the proper workings of local government in doing their financing.

Mr. WHITE. That is our objective, Mr. Chairman.

Senator BENTSEN. Thank you.

Mr. DOTY. On behalf of MFOA, Mr. Chairman, I should like to express our appreciation for what you have done and our desire to re-

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[1] See part 6 of this hearing.

main in a close working relationship with you and your staffs on this matter.

We thank you.

Senator BENTSEN. Thank you very much.

[The prepared statement of Mr. White follows:]

STATEMENT OF CARL L. WHITE, FINANCE DIRECTOR OF SAN ANTONIO, TEX., ON BEHALF OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Chairman, my name is Carl L. White. I am Finance Director of San Antonio, Texas. I am here today representing the Municipal Finance Officers Association, a professional association of over 8,000 state and local governmental finance officials. I am accompanied by Robert W. Doty, MFOA's General Counsel. We appreciate the opportunity to appear before you and to give our views on S. 3370 and related matters concerning regulation of state and local government finance transactions by the U.S. Treasury Department.

The issue which you are reviewing is one which has generated unprecedented controversy within the municipal bond market during the past two years. Too often, the Treasury Department has sought to regulate valid matters, but has overstepped its authority and has far surpassed the degree of regulation which is necessary in order for it to remedy the problems which it seeks to solve.

The reactions of our members finally gave rise to a series of resolutions and a policy statement which were adopted at the MFOA Annual Conference in Houston this past May. Copies of these resolutions and the policy statement are attached to my written statement.

Following our Conference, the MFOA General Counsel prepared a memorandum concerning consultation with the U.S. Treasury Department. The whole issue of that inadequacy of consultation which had occurred prior to that time was sumarized in that memorandum. Further, the memorandum lists those problem areas where the Treasury's regulations and related regulatory actions have been viewed by state and local government officials as excessive. A copy of the relevant portions of this memorandum is attached to my written statement.

Following the completion of our General Counsel's memorandum, the representatives of MFOA and the other public interest groups representing state and local governments opened a dialogue with the Treasury Department concerning the consultative problems. The Department has been receptive to that initiative and has held a large number of meetings with MFOA's Washington staff since that time.

This series of meetings has been arduous and, at many times, frustrating both for state and local representatives and Treasury Department officials. But slowly a number of matters have been worked out. I must add that the active interest of Senator Bentsen, Senator Haskell and other members of this Committee has been most helpful, particularly within the last few weeks. At the time that S. 3370 was introduced, the regulations of the Treasury were most unsatisfactory to us, although we were hopeful of obtaining eventual remedial action.

Much of the remedial action now has been obtained. It consists of the following:

1. Revenue Ruling 78-302, issued in July 1978 to clarify that investment funds (unrelated to bond issues) maintained by state and local governments are not "invested sinking funds" within the Department's May 3, 1978, invested sinking fund regulations.

2. A new Revenue Ruling issued this week to clarify that funds maintained by state and local governments for the purpose of securing bond issues or otherwise to improve their credit likewise are not invested sinking funds. This clarifies questions which were posed by a portion of the earlier Revenue Ruling.

3. Establishment of an arrangement by the Treasury whereby state and local governments will receive expedited treatment on revenue ruling requests under the arbitrage regulations.

4. Public expression of full Treasury Department and Administration support for specific statutory language to correct the overreaching of the December 1, 1977, regulations prohibiting advanced refundings of various public purpose issues, among other types of offerings.

5. Continuing consultation regarding problems raised by the May 3 invested sinking fund regulations. These problems include undue restrictions on the arbitrage certification process and the exclusion of administrative costs from yield

calculations, thus increasing the monetary profits which Treasury gains from the issuance of its regulations, as explained below.

6. Continuing consultation on other matters.

It is unfortunate that matters had to reach their present stage. MFOA believes that adequate Treasury consultation in the beginning would have avoided most of the problems. We trust that future consultation will be directed to this end, and based upon our most recent experiences, are hopeful that this will be the case.

With the actions now under consideration, it is evident that Section 103 and the regulations under it are developing into a federal law of municipal corporations. State and local governments are being told how to conduct their financial affairs. There is an erosion of the ability to issue debt in a flexible way, which has been an essential factor in state and local independence under our constitutional system. The structure of governmental entities is to be regulated under "on behalf of" regulations reported in the press to be under consideration. Regardless of how "workable" any of these regulations may be, in the past, most of such matters were thought to be matters for state and local, not federal, regulation.

It further must be considered that few, if any, persons with state and local government experience are on the staffs of the Treasury or the Internal Revenue Service working on these matters or working on other questions of importance to state and local governments, such as attempts to regulate our pension plans.

And Treasury has a direct conflict of interest in issuing its arbitrage regulations. By limiting yields, the Department forces states and localities to purchase U.S. government securities at rates significantly below market rates. Several billions of dollars of federal securities have been sold in this manner.

Considering all these factors, it is thus a matter of increasing importance that there be much more sensitivity at Treasury to the consequences of its actions than there has been in the past. The Department now has expressed a willingness to listen, and we look forward to the continuation of increased cooperation.

As a result of the Department's recent actions and the continuing consultation, it appears at this time that the Treasury's regulations likely are to be soon in a structure within which state and local governments may function. The Department agrees with us that it has made mistakes in the phrasing and promulgation of its regulations, and has shown some willingness to correct those situations which have been brought to its attention to date. To a certain extent, we must see future actions to amend the invested sinking fund regulations before we will be satisfied completely. Treasury has told us that it will make a number of these amendments.

This leads me to a second consideration of our members. Once it is established that the Treasury's regulations provide a framework within which state and local governments can function—and to a certain extent this depends upon future action—we must then express our concern about the abuse of arbitrage in the municipal securities market. Arbitrage is a technique whereby issuers of tax-exempt obligations may invest at taxable rates the funds which they receive in connection with those transactions. If a sufficient number of arbitrage transactions occur, tax-exempt rates would approach taxable rates. This would mean extremely excessive costs for the financing of public projects and the carrying out of other governmental responsibilities. It would pose one of the most significant threats to the tax exemption which we yet have encountered.

MFOA believes that S. 3370, as it now is framed, could permit unrestricted invested sinking fund and other arbitrage transactions for a period of up to a year-and-a-half, even in refunding transactions where the real abuses lie. We do not believe that this is the best alternative. Rather, we respectfully suggest that you consider modifying S. 3370 so that it provides a more finely-tuned approach. The modifications would:

(a) Include the language which is wholly supported by the Treasury Department and the Administration to correct the overreaching of their December 1 regulations.

(b) Include language defining invested sinking funds narrowly and granting the Department appropriate, though restricted, authority to regulate them in refundings or elsewhere if clear abuses can be established. At present, the statutory language is not at all clear, and we have serious questions as to whether the Department has authority to regulate invested sinking funds.

Adoption of such a modified bill would insure that arbitrage would not find a home in the municipal securities market, thus protecting the tax exemption.

It also would insure that the Treasury Department would find a need to come to Congress to regulate such significant new matters as the invested sinking funds rather striking out on its own through tortuous statutory interpretation to find the authority to regulate a problem which needs regulating. MFOA urges the adoption of S. 3370 in this modified form, but MFOA further reserves the right to change its position to full support of S. 3370 if Treasury's failure adequately to modify the invested sinking fund regulations or to support the statutory language to override the December 1 regulations should lead us to the conclusion that we would be better off under S. 3370.

Mr. Chairman, I appreciate the opportunity to present the views of the Municipal Finance Officers Association. I shall be pleased to answer any questions which you may have.

Whereas, in May 1978, the Treasury Department issued proposed regulations with respect to the investment of taxes and revenues and other financial practices of state and local governments; and

Whereas, these proposed regulations exceed statutory authorizations; and

Whereas, these proposed regulations further fail to take into account traditional and state-mandated practices and state and local practices of sound fiscal management;

Therefore, be it resolved, That the Municipal Finance Officers Association opposes these ill-advised regulations and calls upon the Treasury Department to rescind such regulations and to consult with representatives of the Municipal Finance Officers Association regarding the subject matter of these regulations.

Whereas, in December 1977, the Treasury Department issued proposed regulations with respect to refundings of bonds issued for public purpose facilities of state and local governments, as well as bonds isued fundamentally on the sole credit of individual industrial users; and

Whereas, these proposed regulations exceed statutory authorizations; and

Whereas, these proposed regulations further fail to take into account traditional and state-mandated practices and state and local practices of sound fiscal management;

Therefore, be it resolved, That the Municipal Finance Officers Association opposes these ill-advised regulations and calls upon the Treasury Department to rescind such regulations to the extent that they affect public purpose facilities of state and local governments.

Whereas, the degree of intrusion by the U.S. Treasury Department into state and local government affairs in recent months has increased at an unprecedented rate; and

Whereas, this development is proving to be extremely burdenson and costly to state and local governments and interferes significantly with day-to-day governmental operations; and

Whereas, in a large number of cases, most recently particularly evidenced by Treasury Department regulations regarding refunding of state and local government obligations, investment of taxes and other revenues, and deferred compensation programs, there has been wholly inadequate consultation with state and local governments and their representatives; and

Whereas, the outcome of such consultation as took place furthermore has been wholly unsatisfactory and compels the pursuit of legislative, executive and, if necessary, judicial remedies to redress these ill-conceived incursions of misdirected federal staff activities;

Therefore, be it resolved, That the Municipal Finance Officers Association calls for a comprehensive review of this increasingly serious problem and urges the President and the Treasury Department to respect the governmental status of state and local governments and to adopt a renewed approach of cooperation and mutual determination of common governmental concerns.

From December 1977 through May 1978, the U.S. Treasury Department issued (i) proposed regulations with respect to refundings of bonds issued for public purpose facilities of state and local governments, as well as bonds issued fundamentally on the sole credit of individual industrial users, (ii) proposed regulations with respect to the investment of taxes and revenues and other financial practices of state and local governments, (iii) proposed regulations with respect to deferred compensation programs, and (iv) proposed regulations regarding reporting by state anl local pension plans. These proposed regulations exceed statutory authorizations and fail to take into account traditional and state-mandated practices and state and local practices of sound fiscal management.

These proposals are part of a larger problem. The degree of intrusion by the Treasury Department into state and local government affairs in recent months has increased at an unprecedented rate. This development is proving to be extremely burdensome and costly to state and local governments and interferes significantly with day-to-day governmental operations. In a large number of cases, most recently particularly evidenced by the proposed regulations, there has been wholly inadequate consultation with state and local governments and their representatives regarding such consequences.

The outcome of such consultation as took place furthermore has been wholly unsatisfactory and compels the pursuit of legislative, executive and, if necessary, judicial remedies to redress these ill-conceived incursions of misdirected federal staff activities. The Municipal Finance Officers Association must pursue whatever action is necessary to re-emphasize the governmental status of state and local governments, to renew cooperation within the Treasury Department with state and local governments, and to foster an attitude of mutual determination of common governmental concerns.

JUNE 8, 1978.

From: Robert W. Doty, general counsel, Municipal Finance Officers Association.
To: Representatives of MFOA and of the other public interest groups for State and local governments.
Subject: Consultative problems with the Office of Tax Policy at the Department of the Treasury.

SUMMARY

Recent events have led to a storm of criticism among state and local government officials directed at the U.S. Treasury Department. The immediate stimulus for the criticism is a series of proposed Treasury regulations affecting the state and local securities markets and state and local employment arrangements.

In some cases, the Treasury's goals are understandable, but the particular regulations are overbroad and provide an ill-designed fit for state and local government operations. In other cases, the regulations at best would not have been proposed at all.

But in all cases, improved consultation would have eased the adverse consequences for states and localities flowing from the regulations. Treasury would have gained from the more constructive atmosphere as well through greater regulatory effectiveness and increased political acceptance of its actions.

The Department simply has not engaged in adequate consultation. In particular, Treasury has failed to comply with the mandate of Office of Management and Budget Circular No. A-85, which requires consultation with state and local governments upon the initiation of a regulatory project.

The seeds have been planted, however, for improvement. State and local governments have resolved to communicate the problem. And the Treasury Department, acting pursuant to a Presidential memorandum and an executive order, is attempting to revise its regulatory process, including its consultative procedures.

State and local governments should do everything within their power to assist the Treasury in its efforts. The focus should be upon the new procedures, and state and local officials and their representatives accordingly are urged to make their views known.

I. INTRODUCTION

Within recent months, and in particular during the past few weeks, the level of complaints from state and local government officials regarding actions of the U.S. Treasury Department have increased materially. The complaints center upon a series of tax policy actions by the Treasury Department affecting state and local governments in a variety ow ways. There is now a focus upon the issue of the adequacy of consultation by the Treasury Department with state and local government representatives. An example of the degree of feeling in this area is evidenced by actions taken at the Annual Conference of the Municipal Finance Officers Association in Houston in mid-May.

The actions of these state and local officials is grounded upon the special status of state and local governments as partners in a federal system. Where regulation by the national government is to impact other sovereign entities, close consultative procedures are essential. The Treasury regulations of most concern only highlight the necessity for establishment of active discussions during the initial stages of regulatory action, for these regulations affect the ability of states and localities to finance their operations and to structure wage arrangements with their employees. These areas lie at the heart of governmental operations, and inappropriate federal government attempts at regulation can have serious adverse consequences upon the effectiveness and independence of other American governments.

In expressing their views, the members of MFOA adopted three resolutions directed to the Treasury Department regarding a series of tax regulations proposed during the past 12 to 18 months, and the members further adopted a related policy statement for MFOA action. Copies of these resolutions and of the policy statement are attached as Appendix A.

This memorandum is a direct consequence of those documents. The memorandum seeks to define the consultation issue more clearly through a description of past, present and proposed consultative procedures between the Treasury Department and state and local government representatives. Finally, it makes recommendations for the establishment of satisfactory consultative procedures.

II. CIRCULAR A–85 OF THE OFFICE OF MANAGEMENT AND BUDGET AND ITS RELATIONSHIP TO PAST TAX POLICY PROCEDURES

In 1971, the Office of Management and Budget issued revised Circular No. A–85 to govern consultation with state and local governments in the development of federal regulations. A copy of this Circular is attached as Appendix B.

The Circular emphasizes the importance of affording an opportunity for comment by state and local government officials prior to the issuance of regulations and indeed "well in advance of the formal development" of regulatory material. Specifically, Circular A–85 states that consultation generally should occur "in advance of publication of *proposed* regulations in the Federal Register" [emphasis added]. The Circular adds that: "Federal regulations should not hamper the heads of State and local governments in providing effective organizational and administrative arrangments and in developing planning, budgetary, and fiscal procedures responsive to needs."

All of the Treasury tax regulations at issue are squartly within the scope of Circular A–85.

Although other federal departments and agencies follow Circular A–85, and although various offices within Treasury do so, the Office of Tax Policy has declined to comply. My own experience extends only to the past year-and-a-half, but to my knowledge, the Circular never has been followed during that period with regard to any regulations prepared within the Office. Further, I am informed by several knowledgeable people that Circular A–85 has not been followed for some time.

Instead, a process was developed whereby a group of attorneys experienced in working with state and local governments would be called to Washington to consult with those persons drafting most tax regulations. There are cases in which not even this substitute process was followed.

The substitute consultative process was not wholly satisfactory since the attorneys would not see drafts of the complicated regulations upon which they were to comment until late afternoon of the day of their arrival in Washington. In a given situation, they would review the draft that night, and then would meet with Treasury officials to make their comments on the next day. At that point, they were required to relinquish possession of their copies of the draft.

Of course many useful comments were made through this process, and both Treasury and state and local governments benefitted materially from it. Nevertheless, the process contained serious limitations: The attorneys were not able to consider their remarks over time or to consult, in advance of their meeting at Treasury, on policy matters with the state and local officials they were representing, although later reflection and consultation were possible in most cases. Due to complaints, Treasury was attempting to address some of these problems.

However unsatisfactory the procedures substituted by the Treasury Department for Circular A–85, even those procedures evidently have broken down in a number of respects. The attorneys were not permitted to review some portions of the recent controversial May 3 Treasury regulations regarding yield restrictions on the investment of taxes and revenues by state and local governments and regarding other fiscal practices. And the attorneys were not able to consult with their principals at all even on those portions which they reviewed.

Thus, it is evident that there is a need for the revision of the consultative arrangement. State and local officials have expressed a strong desire in this regard, and Treasury officials likewise have indicated an interest in engaging in closer consultation. The opportunity for mutually satisfactory constructive action thereby is presented.

III. PROBLEMS RESULTING FROM PAST PROCEDURES

In addition to the other difficulties experienced with respect to the May 3 proposed regulations, those regulations disrupt state-manadated and traditional state and local practices of sound fiscal management. Specific comments upon those regulations will be prepared at a later time. But their unnecessary breadth must be viewed as a direct consequence of inadequate consultation.

The consultative process with respect to other proposed regulations likewise has entailed difficulties. As a preliminary mátter to the discussion of these other proposals, it is important to articulate the peculiar impact of proposed Treasury regulations affecting the question of the tax exemption for the interest paid on state and local securities. Unlike other proposed regulations of fedetal departments and agencies, which normally do not affect the regulated areas formally because the regulations are not "final", these particular proposed Treasury regulations do serve as final regulations in terms of their actual impact.

The reason for this result centers around the reliance of the municipal securities market upon tax opinions of bond counsel. Investors demand an unqualified opinion of reputable bond counsel to the effect that interest on the obligations will be tax exempt. If an opinion is qualified, investors simply will invest in other municipal securities which are accompanied by an unqualified opinion.

Where proposed regulations would, when they become "final", impact the tax exempt character of the interest on an issue of municipal securities, the bond counsel opinion must be qualified to that effect. Were the Treasury regulations to apply only to offerings occurring after the regulations are final, the problem would not be present. But the bond market regulations usually have a retoractive application. This is because proposed regulations in this area often refer to a date on or prior to the issuance of the proposal, or not long thereafter, as of which the regulations will govern securities offered. Consequently, these proposed regulations, while subject to revision, operate as final regulations.

The degree to which this regulatory approach is relied upon is evidenced best by Treasury arbitrage regulations under Section 103(c) of the Internal Revenue Code of 1954. These regulations still are in proposed form even though the statute was enacted in 1969. It should be added that the present proposed arbitrage regulations are so complicated as to be unreadable by most professionals, let alone state and local officials who are inexperienced in law. Indeed, computer firms have been organized solely or primarily to assist attorneys in interpreting these regulations.

With a praiseworthy realization of what it has wrought Treasury has indicated that it has an overall goal of simplification of these regulations. Still, the point is that the regulations will remain in proposed form for some time to come, and that they will regulate the municipal securities market during the interim even though they are not final.

In the case of such complicated regulations, the consultative process probably would not function well without the direct involvement of legal professionals. But state and local officials have not been involved at all in the development of most of these regulations, and those officials have been consulted inadequately on other proposed regulations. Unnecessary disputes have resulted.

One such set of proposed regulations was issued on December 1, 1977. These proposed regulations prohibit refundings of state and local government bonds issued for public purpose facilities, such as, for example, airport, convention, mass commuting, sports, trade show, sewage, solid waste and water facilities. The proposal is overbroad, and again, unnecessarily so, for the regulations were issued for the purpose of limiting refundings of bonds issued fundamentally on the sole credit of individual industrial users. There was in fact some consultation on these regulations, but the process required by Circular A-85 was not followed.

At the time the proposed regulations were issued, the Treasury Department expressed a realization that they impacted public purpose issues. Treasury then indicated a desire to resolve the difficulties through statutory amendment. Yet despite this solemn promise, no such statutory amendment ever has been proposed, and there is no reason to believe that one will be proposed in the immediate future.

As another example, in February, the Department issued regulations seriously adversely affecting deferred compensation arrangements of state and local governments. There was no advance consultation whatsoever with respect to these proposed regulations.

And in March, proposed regulations were issued to require reporting by state and local government pension plans. While the individuals working on this latter project did talk on several occasions with state and local government officials, there was no consultation regarding the regulation itself prior to its issuance. The consultation which did occur was a direct result of vociferous state and local complaints after Treasury purported to require the filing of reports by state and local pension officials by means of an "information release" which was not sent to those officials and as to which there was no prior consultation at all.

In a similar vein, Treasury now claims that its regulations governing "qualification" of pension plans apply to state and local governments, although there was no consultation at all on those regulations. Treasury did not even assert the applicability of those regulations to states and localities until years after its regulations were published.

Finally, a series of revenue rulings issued during 1977 raise serious questions as to the degree of understanding within the Treasury Department of the nature and operations of state and local governments. Regardless of the formal procedures for the issuance of revenue rulings, which possibly may exclude consultation, more frequent contact between Treasury and state and local officials may have avoided some of the problems.

For instance, Revenue Ruling 77–261 requires a pooled investment fund of a state and its political subdivisions to file income tax returns because the fund is "classified as a corporation subject to taxation" under the Internal Revenue Code. The ruling acknowledged that the fund was exempt from the payment of income taxes, but required the filing of returns nevertheless.

Taken literally, the ruling would require that thousands of state and local governments, which frequently are "corporations" under state law, must file tax returns, even though they do not pay taxes. General statements have been made in defense of the ruling to the effect that it does not specifically apply to municipalities. Yet the ruling itself fails to articulate any such distinction.

The ruling further places a narrow reading upon the exemption of state and local governments from the payment of income taxes. According to the ruling, the income of the investment fund was exempt because the fund's operations were essential to governmental operations. Thus, by an unfortunate negative implication, the issue is posed of whether state and local governments will be subject to taxation on revenues from services not deemed by unnamed individual IRS officials to be "essential".

Additional problems are entailed in Revenue Ruling 77–164 and –165, which announced that a state university and a community development authority were not "political subdivisions" entitled to issue tax exempt securities under Internal Revenue Code Section 103(a). Only after state and local governments strongly communicated the marketing problems which resulted from these revenue rulings, was a clarification issued to provide that the rulings did not go to the question of whether the particular entities could issue securities "on behalf of" other state or local governments.

Consultation could have avoided all these problems. General and constant contacts over time between Treasury and state and local officials could result in a higher awareness on the part of Treasury officials regarding state and local governments. It also could promote understanding among state and local officials of the problems faced by the Department.

There are benefits to be obtained as well from specific consultation beyond general discussions. When regulations are in process, consultation should be extended to policy decisions and to the particular language under consideration. Such an approach would magnify the consultative benefits.

IV. PRESIDENTIAL MEMORANDUM AND EXECUTIVE ORDER AND RESPONSE OF THE TREASURY DEPARTMENT

On March 23, the President issued an executive order for the improvement of government regulations and a separate memorandum to the heads of the executive departments and agencies "to assure full State and local participation in the development and promulgation of Federal regulations with significant intergovernmental impact". Copies of the executive order and memorandum are attached as Appendix C.

The memorandum outlines a procedure for consultation with state and local governments, which is to commence prior to the publication of proposed regulations. While OMB Circular A-85 is to be rescinded (the memorandum inaccurately refers to the rescission as already having occurred), the memorandum adds in the context of discussing the rescission that: "Nothing in this memorandum shall be construed as in any way diminishing the affirmative obligation of the executive departments and agencies to actively seek out, encourage, and facilitate submission of State and local comments in the development of Federal regulations in any other ways appropriate to the agency and the proposed regulation."

The various departments and agencies now are in the process of developing their proposals for implementing the executive order. On May 24, the Treasury Department published a draft of its implementation report. The report contains a description of the current process for the development of Treasury regulations and a draft of the proposed process to be followed. A copy of the draft report is attached as Appendix D.

In Treasury's description of its current consultative procedures, a reference is made to steps taken under Circular A-85 as a part of that process. With respect to the Office of Tax Policy of Treasury, this description simply is not accurate. Nevertheless, the description constitutes a recognition by the Department of the applicability of the Circular to the regulatory process. This concept of early consultation is carried forward into the draft of the proposed process.

A summary of the proposed process emphasizes a "work plan" as the "key element". The work plan must inform the Secretary of a variety of matters, including, among other subjects, a justification of the regulatory project, a discussion of alternatives, the plan for obtaining public comments, and target dates for completing various steps. The work plan may be abbreviated for regulations which are "not significant".

The notion of whether a regulation is "significant" focuses upon publication of regulations in the Federal Register and their codification in the Code of Federal Regulations. Determinations may be made, with Secretarial approval, that regulations, even if so published and codified, are not significant, subject to express justification. Any regulation not so published or codified is deemed not to be significant.

The work plan is only one technique to be employed under the new procedures. Treasury bureaus or offices also will be required to publish in the Federal Register semi-annual agendas, which may be amended from time to time, of significant regulations under development.

The semi-annual agendas will constitute public notification to interested parties, including state and local governments, of pending Treasury regulatory projects. Participation may then take place. According to the President's memorandum of March 23, after state and local represenatives notify Treasury of their interest in a matter covered in a semi-annual agenda, "the [Treasury] shall develop a specific plan for consultation with State and local governments in the development of that regulation." Treasury's draft echoes this mandate, for it adds that in the development of regulations, each bureau and office is to give the public, including particularly, state and local governments or their representatives, "an early and meaningful opportunity to participate in the regulatory process." Examples are given of methods of achieving this laudable goal.

The semi-annual agendas are not to be limited to new regulations to be developed, for they are to include, as well, existing regulations selected for review. Constructive criteria are stated for selecting regulations for the review process. Representatives of state and local governments should utilize the review technique fully to obtain the amendment of inappropriate regulations and the elimination of unnecessary ones.

As yet another step, in the case of significant new regulations which may have certain "major economic consequences", a regulatory analysis must be prepared. The analysis "shall be a careful examination of alternative approaches" and is to be undertaken early in the regulatory process to aid reviewers and the Secretary. A procedure is to be established for a draft and for a final regulatory analysis. Copies of the draft and final analysis are to be available publicly.

In short the new process emphasizes consultation and openness. The Treasury Department is making a genuine effort to implement the letter and spirit of the executive order, and its achievements should be recognized. The proper focus now should be upon assisting the Department in reaching the high standards which it is setting for itself.

V. CURRENT STATUS OF CONSULTATION WITH THE TREASURY DEPARTMENT

Based upon discussions with OMB officials, Circular A-85 will remain effective until this Fall when the Treasury and other federal departments and agencies have their final consultative procedures in place. Therefore, the Circular still governs existing proposed regulations and those regulations which will be proposed in the interim.

Treasury's draft implementation report also will be effectvie in certain respects during this period. The report states that: "All Treasury bureaus and offices will be expected to comply with [the draft report] effective May 22, 1978, even though it is subject to change as a result of public comment on this report as a whole. * * *"

So in the interim, both the draft report and Circular A-85 govern the regulatory process. An exception is stated in the report for: "Any regulation in the process of preparation on [May 22] which, on or prior to September 1, 1978, either is published in the Federal Register in proposed form, or has been, or was scheduled to be, the subject of a public hearing. * * *"

For excepted regulations, no work plan or regulatory analysis is required unless directed "by higher authority".

This exception confronts the Department and state and local governments with the issue of what action to take as a consequence of the failure of the Treasury Office of Tax Policy to follow Circular A-85 with respect to existing proposed regulations. Unless close consultation can occur on the several sets of proposed regulations affecting state and local governments, little direct input will have occurred on those regulations either under existing procedures or the new process. The Secretary should consider what is to be done about violations of the regulatory process.

And state and local governments likewise should consider their own course of action. There is reason to believe that state and local governments and the state and local associations have standing to enforce Circular A-85 through judicial action. An investigation of these issues is to be conducted. It may well be that Treasury can be compelled to comply with Circular A-85.

VI. ESTABLISHING SATISFACTORY CONSULTATIVE ARRANGEMENTS FOR THE FUTURE

The consultative process is a vital part of regulatory action. State and local governments benefit substantially from that process through insuring that regulations are not overbroad, do not impose unnecessary expenses or red tape, and do not limit valid state and local government flexibility. Consultation is valuable also to the Treasury Department, for it provides a continuous flow of information to form a basis for effective regulatory action. It is essential to the Department to maintain a good working relationship with state and local governments so that the Department's effectiveness is increased through the political process.

Since OMB Circular A-85 will operate only for a few more months, and since it will be replaced by the new procedures, it is vital to ensure that the new procedures are adequate to the task. Written comments must be submitted regarding the draft on or before July 24 to the Assistant Secretary (Administration), Room 3442 Main Treasury, Department of the Treasury, Washington, D.C. 20220. Attention: RIIP. Further information may be obtained from Anthony V. DiSilvestre, Regulatory Improvement Implementation Project (RIIP) Coordinator, at 202-566-2966. State and local officials are encouraged to submit their comments in a timely fashion.

VII. CONCLUSIONS

While the issue of consultation between the Treasury Department and state and local governments is quite controversial at present, the solution also conveniently is present as well. By directing attention to the Treasury's draft implementation report prepared under the March 23 executive order of the President, Treasury and state and local governments can agree upon a mutually satisfactory arrangement which will benefit all concerned.

It is essential for the Treasury Department to appreciate the degree to which its tax policy actions have proved detrimental to state and local governments and the degree to which state and local officials are offended thereby. Without a full recognition of the special status of states and localities in our federal system, the present series of running battles will continue and perhaps will break out into even more explicit hostility.

This should not be the case. Neither the Department nor state and local governments would benefit from it. One indisposable element of a preventative is the improvement of the consultative process. It is time to restructure that process.

Senator BENTSEN. We art pleased to have with us the mayor of Birmingham, Ala., Mayor David Vann, who is appearing on behalf of the National League of Cities and the U.S. Conference of Mayors.

Mr. Mayor, please come to the witness table and introduce your associate to us.

STATEMENT OF MAYOR DAVID VANN OF BIRMINGHAM, ALA., ON BEHALF OF THE NATIONAL LEAGUE OF CITIES AND THE U.S. CONFERENCE OF MAYORS, ACCOMPANIED BY JIM WHITE, FISCAL ADVISER TO THE CITY OF BIRMINGHAM

Mayor VANN. Thank you, Mr. Chairman.

Mr. Chairman and Senator Haskell, this is Mr. John White, who is a fiscal adviser to the city of Birmingham. Although I started my practice of law with a bond firm, this is a highly technical field, and I might need his help in answering some of your more technical questions.

I want to thank the committtee and its members for giving us an opportunity to come here today to speak on behalf of the U.S. Conference of Mayors and the National League of Cities.

As you know, we represent some 15,000 municipal governments. I might say that that means 15,000 different formulas of local muncipal financing because that is a very important part of the variety in life that occurs in this country. It is very hard to speak on behalf of all. I am sure that I will digress to some degree on the experience that I have as mayor of a particular city.

I want to assure you that the matters here have been placed forcefully into our consciousness by the Treasury's proposed action. We feel that the proposed regulations do invade a territory over which the Treasury really has no authority. It really is a very serious problem of the intervention of local governmental powers by the Treasury.

As you know, arbitrage matters are of concern to cities. The exemption of taxation should be available for legitimate public purposes and not merely for the purpose of producing an arbitrage profit. We certainly recognize that and we think the Treasury has a legitimate concern in that area. If there are too many bonds left oustanding for too long, they will drive interest rates up and in the long run eliminate the interest rate advantage that is available to State and local governments and which is vitally important to us.

So, we come here speaking from a point on which, on the core issue, we don't think there is basic disagreement. In fact, the policy of the

National League of Cities, a copy of which is attached to my statement, specifically provides that: "Issuing new municipal obligations or refunding prior issues of municipal obligations purposely for the purpose of gaining arbitrage profit by investing in Federal Government bonds is an abuse of the purpose for which municipal bonds are normally used. Such arbitrage bonds should not compete for scarce capital needed for development and other lawful refunding purposes. We, therefore, are opposed to the issuance of such bonds."

We conclude that, "We also oppose the Federal taxation as 'arbitrage bonds' of those municipal obligations not issued for the primary purpose of such profit."

In this case, we have regulations issued under the Congress arbitrage statute which do not reach, in our judgment, the area that the Congress had in mind. If the Congress had in mind that you should not issue bonds for the purpose of arbitrage, then they were talking about the proceeds of the bonds. This regulation seeks to regulate all local funds, whether they are from bonds, or from taxes, or from licenses, or from operational charges of airports, or from garbage collection, and so on. We think that it is much too broad and that it take a leap beyond the point that is necessary to cover the field.

Senator HASKELL. Excuse me. Let me interrupt at this point, please.

Are you speaking of the regulations as they existed prior to the revenue rulings mentioned by the chairman, or are you speaking of the regulations as amended by the revenue rulings?

Mayor VANN. Let me say this. I understand that there were rulings issued. I have not had a chance to study those rulings. But, as I understand the regulations—although as you point out, they are still "proposed" regulations; but as far as we can tell, there has never been anything other than a proposed regulation—the regulations are still outstanding.

Let me apprise you of part of my problem as a mayor.

In 1895, we had an election in our town, and people voted a tax on themselves on the condition that that tax be used solely for the payment of principal and interest on bonds.

Since 1908, as near as I can determine, for the last 70 years, the city has maintained a sinking fund. That sinking fund has been used in the prospectus for the sale of every bond issue that has been sold by the city of Birmingham as a fund to back up the credit and to assure the bond holders they would be repaid.

We have about $6 million in taxes that now go into that a year. We have about $1.2 million or $1.3 million in transfers of charges made at airports and other things that have been built with bonds. As a matter of policy, we put the revenue back into the bond issue. We also have interest income from the investment of those proceeds.

Frankly, I believe, as the mayor of the city, that it is my duty and responsibility to invest those funds year after year at the best interest rate that I can invest them at. I think to have a regulation that regulates the interest rate, potentially, at which those funds could be invested, is beyond the point at which Congress intended the Treasury to act. To be honest with you, in talking with members of the Treasury staff—and we have been in consultation with them—I am convinced that it is beyond the intent of what they were trying to do. I think they were primarily trying to reach practices in advance funding, in computer refunding and other things that the Assistant Secretary spoke about here this morning.

However, the fact is that the regulations are of such broad language that they reach all funds from which it is intended for bond interest and principal to be paid. I certainly believe our sinking fund is one of those.

Now our recourse is to get a letter or ruling saying that we are somehow outside the rules. But I will say to you that we will seek such a ruling and we hope that we will get such a ruling to protect our interest. But to me it is still undesirable for a city to have a Federal regulation outstanding which, if anybody reads it, casts grave doubt on a practice of some 70 years basis. I think it is frankly a conservative practice, a sound practice, a good fiscal management practice to have a way of giving an assurance. When we ask the voters to approve a bond issue, we tell them that we have a sinking fund, that their taxes are already going into that sinking fund, and that it is not going to raise their taxes if they approve this bond issue.

For instance, last year we passed a $62 million bond issue by our citizens. We passed it with as much as 70 percent approval. Without the sinking fund we would probably have been in the same position as most cities in this country of having their bond issues rejected by the voters.

So, it is a sturdy, stable type of provision that we are really concerned about.

Let me say that ours is just one example. Many cities in Alabama copy the technique of the largest city. Many cities in other States do, too. If you take the 15,000 cities, you will find many kinds of sinking funds that are far removed from the intentions or the desires or the worries of the bond market or anyone else that gave rise to the issuance of these very broad regulations.

Now city officials are confused. Mayor Lou Murphy of Tucson, Ariz., for instance, has a 5-year capital plan. Because he cannot use a sinking fund, it is going to cost $22 million more for that program. I suspect that he will probably come here and ask you all to make some Federal grants to him to help cover the $22 million that he could cover himself with his own means, except for these regulations.

I think that that is a serious problem. If the Treasury can, by fiat, declare tax receipts are the equivalent of bond proceeds, where is the limit on the right of the Treasury to intervene in local financing?

There is no clear answer to that question and that is the reason the U.S. Conference of Mayors this summer, in Atlanta—and I will say that I made the motion—approved a resolution asking the Treasury to rescind the May 8 regulation.

Our concern was shown to be warranted by the July 7 ruling, which declared revenues that were not even used to repay principal and interest on bonds could be treated as bond proceeds.

The 1969 arbitrage law did not contemplate such broad action, and the proposed regulation went well beyond the one proposed and withdrawn in 1972. Combined with the December advanced refunding regulation, a situation had been created which is both unsettling to the market and threatening to the future of local financing practices. In the latter case, we think the Treasury failed to distinguish between refunding bonds issued to finance public facilities and bonds that were issued basically for private purposes.

Since the issuance of the May 8 regulation, we have had representatives of States and local governments confer with Treasury officials. We are satisfied that the Treasury's objective, the prevention of gross acts of arbitrage, is reasonable. But we are convinced that Treasury did not intend to eliminate traditional local practices, local practices that grew out of conservative fiscal policies such as those I described—the traditional use of sinking funds that were derived from pledged taxes and other revenues and in no way came from bond proceeds.

While we think we have made substantial progress, we think the regulations that have been issued and the statements that have been issued are important; but that we do still feel that the rulings go far beyond the point which they should go and they set a precedent that we think is dangerous.

We think we are breaking the logjam and maybe, as the MFOA witness said, we will find a world in which we perhaps can live together. I think you have to face the fact that the Treasury under this administration, and under the Eisenhower, Nixon, Ford, and Franklin Roosevelt administrations, has grave doubts and objections to the use of municipal bonds with tax-exempt interest. So there is a general clash of policy between Treasury and the local governments.

But, I also feel that in this day and time, when we are trying to insure sound fiscal policies and cities, we should not take action that threatens to disrupt sound fiscal policies.

Senator BENTSEN. Mr. Mayor, I think you will find us in full accord with that point of view. Hopefully, that will be the ultimate outcome of it.

But I would say to you, as I said to the previous witness, that we would hope that you keep us apprised of the position of the League of Cities and the U.S. Conference of Mayors.

If we do not have a satisfactory resolution of this, we will then look ultimately to a legislative resolution.

Mayor VANN. We would hope that you would let us file comments on the rulings that have been issued.[1]

Senator BENTSEN. We would be very pleased to have them.

Senator Haskell.

Senator HASKELL. Thank you, Mr. Chairman, but I have no questions.

I appreciate the mayor coming, and I also think that your comments on yesterday's rulings would be most helpful and interesting.

Senator BENTSEN. Mayor Vann, thank you very much for coming. We were very pleased to have you.

[The prepared statement of Mayor Vann follows:]

STATEMENT OF HON. DAVID VANN, MAYOR, BIRMINGHAM, ALA., ON BEHALF OF THE NATIONAL LEAGUE OF CITIES AND THE U.S. CONFERENCE OF MAYORS

Mr. Chairman, I am Mayor David Vann of Birmingham, Ala. I am here today to testify on behalf of the National League of Cities and the U.S. Conference of Mayors concerning the proposal to void regulations proposed by the Treasury

[1] Supplementary statement by Mayor Vann appears in pt. 6.

Department on arbitrage and industrial development bonds. As you know, the two city organizations for which I speak today represent over 15,000 of the country's municipal governments.

The issues involved in the proposal before you may seem overly technical for a Mayor, and I cannot claim the competence of a bond counsel or a finance officer concerning such things as computing bond yields. However, I assure you that these matters have been placed forcefully into our consciousness by the Treasury's proposed action. While in hot pursuit of arbitrage, Treasury has clearly invaded territory over which, we believe, it has no authority. The regulation should be substantially rewritten.

It is important, I think, to recognize the complexity of the arbitrage issue and to appreciate the ligitimacy of Treasury's concern. Few would argue that public entities should be allowed to use their right of tax-exemption without restrictions to produce profit. That exemption is available only for legitimate public purposes and, if deflected from those purposes into the production of revenue all issuers and their citizens will eventually suffer. Too many bonds left outstanding for too long will drive interest rates up and in the long run reduce or eliminate the interest rate advantage to State and local governments. Furthermore, the arguments of those who see tax-exempt municipal bonds as a questionable federal subsidy in any event would be strengthened if a larger and larger portion of the issues appeared to be unconnected with any legitimate public purpose.

There is, therefore, no basic disagreement over the core issue. NLC policy states:

"Issuing new municipal obligations or refunding prior issues of municipal obligations purely for the purpose of gaining arbitrage profit by investing in Federal Government bonds is an abuse of the purposes for which municipal bonds are normally used. Such arbitrage bonds should not compete for scarce capital needed for development and other lawful refunding purposes. We, therefore, are opposed to the issuance of such bonds."

The disagreement arises in the attempt to identify those bonds.

The NLC policy concludes:

"However, we also oppose the federal taxation as "arbitrage bonds" of those municipal obligations not issued for the primary purpose of such profit."

Both of the regulations which are the subjects of this legislation fail to identify properly the proscribed practice. This is most obvious in the case of the sinking fund regulation.

To get at a novel refunding technique involving a sinking fund that has the appearance of an abuse and which may well be prohibited under existing regulations, Treasury cast a net that we believe is much too broad. It required a leap of imagination that concluded that locally collected taxes and other revenues could be treated as though they were proceeds of a bond issue. It covered not only the targeted practice, but other such traditional practices as the 75-year-old sinking fund in Birmingham. Many other cities have traditionally employed debt retirement funds as a prudent fiscal management too. City officials are concerned and confused. My good friend Mayor Lou Murphy of Tucson, Arizona, tells me that the increased costs for financing the 5-year capital improvements plan for his city which will be caused by this regulation will total over $22 million. If the Treasury Department can by fiat declare tax receipts to be the equivalent of bond proceeds, where is the limit on the right of Treasury to intervene in local financing? There is no clear answer to that question and for that reason the U.S. Conference of Mayors, at its recent Annual Meeting, approved a resolution asking Treasury to rescind the May 8 regulation. Our concern was shown to be warranted by the July 7 IRS ruling which declared that revenues that were not even used to repay principal and interest on bonds could be treated as bond proceeds.

The 1969 arbitrage law did not contemplate such broad action; and the proposed regulation went well beyond the one proposed and withdrawn in 1972. Combined with the December advanced refunding regulation, a situation had been created which is both unsettling to the current market and threatening to the future of local financing practices. In the latter case, the Treasury failed to distinguish between refundings of bonds issued to finance public facilities and bonds issued for basically private purposes. When the regulation was issued, the Treasury committed itself to proposing legislation to remedy the problem. That legislation has not been produced.

The proposal before you would freeze the situation at the point prior to the issuance of the two regulations. Without further Treasury action that would be a reasonable and necessary action. Such a moratorium should not be instituted lightly, the market impact could be great and damaging. If there has been adequate consultation prior to the issuance of the regulation, the situation might be quite different. Treasury might well have had a better understanding of the likely impact on local financing practices; and city officials might have had a better understanding of Treasury's intent. However, that did not occur.

Since the issuance of the May 8 regulation, representatives of state and local governments have conferred with Treasury officials on several occasions. We are satisfied that Treasury's objective—the prevention of gross acts of arbitrage—is reasonable. We are convinced that Treasury does not intend to eliminate traditional local practices involving, through conservative fiscal policies, the use of sinking funds derived from pledged taxes, other revenues, and other truly non-bond income. The consultation has been useful and progress has been made with respect to general operating funds, but major problems continue to be raised by the regulations.

Until yesterday, Treasury had not yet produced alternatives. I have been told, however, that three important steps have been taken. First, advanced refunding legislation will be forwarded shortly. Second, a revenue ruling was issued yesterday that Treasury says protects most traditional debt service funds from the arbitrage regulation. And third, a commitment to speedy rulings has been made but will require case by case determination with respect to long established and accepted financing methods. These are promising developments. Treasury is also reworking the May 8 regulation with the likelihood that it will be greatly improved. The log jam seems to be breaking and I think Congressional pressure has been helpful, especially Senator Bentsen, with the introduction of S. 3370.

We cannot be completely confident, however, that these issues can be resolved satisfactorily without legislation. If the market can be protected from severe dislocations that could result from a moratorium, this would be desirable. If Treasury's decisions do not adequately distinguish abuses from legitimate financing practices, then the moratorium should be declared. Given the developing situation, Mr. Chairman, we would like to reserve the right to suggest amendments to the legislation, if Treasury's decisions fall short.

In closing, Mr. Chairman, one of the obstacles to resolving these matters adequately is the impossibility of getting judicial review of the Treasury rulings and regulations. After a Treasury regulation is issued, bond counsels will not give a clear opinion on a covered issue and there is, therefore, no way to obtain judicial review of the validity of Treasury's action. To deal with this problem, the League of Cities and the Conference of Mayors suggest that Congress enact legislation to permit judicial review of Treasury rulings or regulations, whether issued in temporary, proposed or final form.

UNITED STATES CONFERENCE OF MAYORS

Federal Tax Policy Impact on Local Financial Management and Local Economies

Whereas, federal tax policy and regulations administered by the Treasury Department and the Internal Revenue Service have significant impacts on local government budgets and economies as well as cities' financial management; and

Whereas, the timing, amount, and purpose of tax exempt bonds issued by local government are a key element of local financial management; and

Whereas, local prerogative to issue and control tax exempt bonds is a critically important feature of the nation's intergovernmental system; and

Whereas, in May, 1978 the Treasury Department issued proposed regulations with respect to the investment of taxes and revenues which fail to take into account traditional and state-mandated practices and state and local practices of sound fiscal management; and

Whereas, federal tax policy decisions significantly determine the future direction of urban investment, Now, therefore, be it

Resolved, That the U.S. Conference of Mayors calls upon the Treasury Department to fulfill its responsibilities to the nation's cities by recognizing the impact its tax and regulatory decisions have on cities; and be it further

Resolved, That the U.S. Conference of Mayors calls on the Treasury Department to insure that adequate consultation with local government occurs prior to issuance of regulations or submission of legislative proposals to Congress which affect tax exempt bonds or the markets in which they are traded as well as industrial development bonds, tax credits, and other similar tax policy proposals; and be it further

Resolved, That the U.S. Conference of Mayors calls upon the Treasury Department to rescind the May 3, 1978 proposed regulations on the investment of taxes and revenues and to consult with local government regarding the subject matter of these regulations; and be it further

Resolved, That the U.S. Conference of Mayors opposes federal regulation of municipal issues, but does support cooperative efforts among various levels of government to improve the operation of the tax exempt bond market by establishing more uniform and rational disclosure requirements and by supporting voluntary efforts to standardize local government budgetary and accounting information.

(Adopted by U.S. Conference of Mayors membership during 46th annual meeting, Atlanta, Ga., June, 1978.)

RESOLUTION NO. 14

In Opposition to Disallowal of Tax-exempt Status for Bonds Sold to Refund Existing Tax-exempt Industrial Development Bonds

Whereas, in 1968 the Congress enacted provisions to tax "industrial development bonds" of the states and their political subdivisions; and

Whereas, the Congress employed for this purpose an over-broad definition which encompasses not only bonds issued to finance industrial improvements, including pollution control facilities, for private industry, but also bonds issued to provide many public facilities, but the Congress nevertheless continued the tax exemption of bonds issued for most facilities by including a special exception for certain listed exempt activities, including public housing, airports, convention halls, piers, and mass communting, water and power supply facilities, among others; and

Whereas, on December 1, 1977, the Treasury filed proposed revisions of its regulations under the 1968 statute so as to tax, for the first time, bonds issued to refund bonds originally issued for the listed exempt activities, and made the revisions effective as of November 4, 1977; and

Whereas, such revisions, although in proposed form, have the immediate practical effect of making it impossible to issue any more tax exempt refunding bonds for the listed exempt activities; Now, therefore, be it

Resolved, That the National League of Cities urges the Treasury Department to make immediate modification of said revisions of its Regulations so as to reaffirm the tax exemption of state and political subdivision bonds issued to refund bonds originally issued to finance public facilities; and be it further

Resolved, That the Congress is urged to clarify the language of the industrial development bond tax statute so as to deny the ability of the Treasury Department, by changes in its regulations or by rulings, to tax any state or political subsivision bonds issued to finance or refinance public facilities.

(Approved by the Membership of the National League of Cities, December 7, 1977.)

RESOLUTION NO. 15

Judicial Review of Treasury Denials of Tax Exemption of Municipal Bonds

Whereas, the Treasury is exempt from generally applicable procedures for judicial review of federal administrative action; and

Whereas, in the case of Treasury action denying the exemption of proposed municipal bond issues, the practical effect is that it is impossible to bring out the issue on a tax-exempt basis; and therefore there is no way to have any judicial review of the validity of the Treasury action; Now, therefore, be it resolved,

Thas the National League of Cities urges Congress to enact legislation to permit the issues of proposed obligations to procure judicial review of Treasury rulings or regulations, whether issued in temporary, proposed or final forms, denying their exemption as obligations of a state or political subdivision.

(Approved by the Membership of the National League of Cities, December 7, 1977.)

Senator BENTSEN. Our next witness will be Mr. C. Willis Ritter, Esq.

Mr. Ritter, welcome to the committee. Would you please introduce your associates to us for the record, please.

STATEMENT OF C. WILLIS RITTER, ESQ., HAYNES & MILLER, WASHINGTON, D.C., ACCOMPANIED BY BRUCE COLEMAN, ASSOCIATE, HAYNES & MILLER, AND KAREN ELLIS, LAW CLERK, HAYNES & MILLER

Mr. RITTER. Thank you, Mr. Chairman. I am Willis Ritter of the law firm of Haynes & Miller in Washington, appearing on my own behalf. With me are my colleagues Mr. Bruce Coleman, to my right, and Ms. Karen Ellis to my left.

I have submitted a statement of my written views, expressing my views with respect to S. 3370, the proposed regulations of December 1977, and May 1978. I have accompanied that with a biography and a legislative history with respect to the arbitrage provisions of section 103(c).

Senator BENTSEN. Your entire statement will be placed into the record.

Please proceed.

Mr. RITTER. Thank you, Mr. Chairman.

Late yesterday afternoon we received copies of Revenue Ruling 78-348 and 78-349 and a press release accompanying those two revenue rulings indicating certain anticipated further amendments to the proposed regulations related to the pledge of gifts and bequests as collateral for certain bond issues on the part of charities.

I would like to address my comments, rather than to the specific provisions of S. 3370, to what I perceive as the causes for S. 3370, trends which we have noted in our law practice and our observations over the years.

First, we believe there is a wide perception on the part not only of State and local governments, but also on the part of practicing bond attorneys, and tax attorneys and students of this area that in a number of respects certain provisions of the proposed IDB regulations and the so-called invested sinking fund regulations simply go beyond the statutory limits that were authorized by Congress in 1968 and 1969.

We recognize, Mr. Chairman, from our perspective, and have written and lectured to this point, that there are legitimate policy considerations in these areas. There are real policy questions with respect to the advance refunding of certain types of industrial revenue bonds. There are real policy questions with respect to the use of invested sinking funds in the context of advanced refundings, perhaps in other contexts, perhaps with or without the use of so-called guaranteed forward supply contracts.

Our concern is that these policy decisions have, particularly in the last 2 years, been made largely in a vacuum. They have been made in the Treasury Department and in the Internal Revenue Service. They have been made without an opportunity for representatives of State and local governments to express their views before action is taken.

They have been made without consultation with the Congress. They have been made in a manner which, while labeled as proposed regulations, is widely recognized as being final upon the date of publication.

For example, on November 4, 1977, Treasury put out a press release announcing that at some future time proposed regulations would be issued which would limit the advance refunding industrial revenue bonds. Almost a month later, on December 1, 1977, those proposed regulations were issued, stating that they would be effective with respect to any issues which had not been closed 4 weeks earlier.

It is very difficult, I submit, Mr. Chairman, for affected States and local governments and their representatives to have any input into the process when the rules are made effective 4 weeks before one even knows what the rules will be.

As a practical matter—and I think this has been brought out in the earlier testimony—today's hearing and the introduction of bills, such as S. 3370, really present the only effective forum for State and local governments to secure any kind of review of the policy decisions and the statutory interpretations embodied in the proposed regulations adopted by the Treasury Department.

As Secretary Lubick acknowledged in his testimony earlier this afternoon, it is very, very difficult, as a practical matter, to secure any form of judicial review of adverse determinations under section 103.

One of our recommendations—it is in our written statement—suggests that some procedure must be established by which judicial review of decisions made by the Treasury Department and the IRS with respect to tax exempt bonds could be implemented by law, other than the very cumbersome and largely unworkable audit procedures which are available now.

There are in the American Bar Asssociation Section of Taxation proposals being developed for submission to the Congress which provide for judicial review. I would hope that in connection with your study of these matters, you could participate with representatives of the ABA in that process.

I think the second cause for concerns that have come up—and this has been expressed—is a perception that in many respects these regulations simply go beyond what is dictated as sound weighing of the mutual interest of the Federal Government and State and local government.

I believe that the Treasury has a tendency, upon the identification of a particular problem, to promote a very broad solution to it, if the Treasury perceives a problem with advance refundings of—

Senator BENTSEN. You know, that isn't unique to Treasury in the executive branch.

Mr. RITTER. So I am told by my partners who specialize in dealing with other agencies, Mr. Chairman.

In an effort to deal with perceived abuses in the advance refunding of pre-1968 industrial revenue bonds, the Treasury simply elected to effectively eliminate all advance refundings of all types of industrial revenue bonds, whether it be a pre-1968 IDB, an interest-cost saving situation, or an airport, or virtually any other thing. I was delighted to hear Secretary Lubick, this afternoon, as quoted in "The Bond Buyer," this morning, indicate that after a considerable period of time, the Treasury is now prepared to propose legislation to correct the imbalance in this respect.

There has definitely been a growing perception over the years that Treasury operates in a vacuum, that Treasury is not willing or does not care to consult with people who could be adversely affected by the proposed regulations. Part of this stems from a concern on the part of the Treasury Department that once the industry—State and local governments—begins to hear that the Treasury may be considering imposing regulations to limit or restrict some particular financial practice, that will immediately stimulate a rush to the market. There was some of that in the fall of 1977, as people began to hear rumors about the industrial bond regulations. There was certainly a good deal of that in March and April of this past year, as people became aware of the fact that Treasury might act with respect to invested sinking funds.

But it seems to me that once the Treasury begins to consider acting in these areas, it is, as a practical matter, impossible to keep that secret, as history has indicated, and that the Treasury could possibly have eliminated a good deal of the difficulties which it faced in the last 4 months by encouraging a more open participation by various elements of the industry before taking action.

I would also like to comment briefly, if I may, on the specific areas under consideration, particularly with respect to the invested sinking funds.

Revenue Ruling 78-302, which was coincidentally published just 4 days before last month's hearing by the Treasury Department, which sought to clarify some of the provisions of the regulations, followed by yesterday's revenue ruling, also published just before today's hearings, are helpful, I think, in clarifying the kind of situations to which the Treasury is directing itself in the invested sinking fund regulations.

My fundamental problem, however, is that those revenue rulings, as with the invested sinking fund regulations, assume that the Treasury has the statutory authority to impose yield restrictions with respect to revenues.

A review of the legislative history continues to convince me, and frankly I believe a number of my colleagues, that no matter how many times the Treasury Department and its representatives say that they have the authority under the statute, they simply do not.

In 1969, Congress imposed limitations on the investment of proceeds. Revenues to be received by a municipality 10 years from now, I submit, are not proceeds of today's bond issues. I further submit that proceeds of today's bond issues cannot, in any realistic sense, be treated as replacing moneys which will be received 10, 15, even 20 years from now.

The Treasury may be correct as a policy matter, Mr. Chairman. It may well be that limitations should be placed on some form or another on invested sinking funds. But, it seems to me that if that decision is to be made, it should be made by the Congress. It should not be made by the Treasury, concluding on its own that there is a problem and then moving to deal with it, without regard to whether or not it has the statutory authority to do so.

Senator BENTSEN. Mr. Ritter, we are going to have to ask you to conclude your testimony because of limitation of time. You have dealt with some very substantive points in a very obviously carefully prepared piece of testimony and one that is going to cause some more probing on our part as to the original intent in the previous legislation.

We would be pleased to have your entire testimony in the record.

Mr. RITTER. Thank you very much, Mr. Chairman.

Senator BENTSEN. We thank you, sir.

[The prepared statement of Mr. Ritter follows:]

STATEMENT OF C. WILLIS RITTER, ESQ., OF HAYNES & MILLER, WASHINGTON, D.C.

Mr. Chairman; I appreciate this opportunity to appear before this Committee to discuss the impact of recent proposed regulations issued by the Treasury Department and the Internal Revenue Service with respect to the sale of tax-exempt municipal bonds by state and local governments.

SUMMARY DISCUSSION AND RECOMMENDATIONS

S. 3370, introduced by Senator Benson, would, if enacted, have the following direct impacts:

(1) The proposed regulations of December 1, 1977, relating to advance refunding of industrial revenue bonds, would be suspended. In effect, this would retroactively authorize advance refundings of industrial revenue bonds until such time as Congress acted, or reinstated the Treasury's regulatory authority.

(2) The proposed regulations of May 8, 1978, together with Rev. Rul. 78-302, would be suspended until such time as Congress specifically acted or reinstated the Treasury's regulatory authority in these areas.[1] This would have the effect of retroactively authorizing a substantial number of invested sinking fund deals; would counteract the statement in the Press Release accompanying Rev. Rul. 78-302 with respect to bad faith opinions of counsel; and would restore discount and administrative costs to the computations of yield.

(3) The Treasury Department would be forbidden to issue any further interpretations of Section 103(c), either through regulations or through rulings, until the end of 1979.

The immediate cause of S. 3370 is the perception—widely held among representatives of state and local governments—that the Treasury's exercise of its regulatory authority has gone beyond what Congress really intended, in at least three ways:

(1) A number of provisions in these proposed regulations arguably go beyond the statutory limits embodied in Sections 103(b) and 103(c): such as the proposed treatment of taxes and other revenues as bond "proceeds" for purposes of arbitrage yield restrictions; the proposed elimination of bond discount in the computation of yield for Federal arbitrage purposes; and the virtual denial of the right of many municipalities to advance refund quasi-industrial revenue bond issues.

Since, as a practical matter, it is extraordinarily difficult to mount a judicial challenge to proposed regulations, Congressional review of the sort envisioned in S. 3370 is the only effective remedy for the State and local governments adversely affected by the Treasury's actions.

(2) As a policy matter, these proposed regulations go substantially farther than would be dictated by a sound weighing of the mutual interests of the Federal Government and State and local governments which they purport to regulate. For example:

(a) The December, 1977, proposed regulations relating to advance refundings of industrial revenue bonds appear to have been inspired the average life
by advance refundings of pollution control bonds for purposes of extending the average life of tax-exempt debt. However, rather than dealing with the particular transactions which it perceived as abuses, it took the opportunity to impose a sweeping prohibition against advance refunding of all types of industrial revenue bonds for whatever purpose. The Treasury Department, itself, acknowledged that these proposals

[1] This suspension would also apply, presumably, to Rev. Ruls. 78-348 and 78-349, published on Aug. 23, 1978.

went farther than necessary and indicated that it would propose corrective legislation to the Congress. To date, no action has been taken resolve the problem.

(b) The May 8, 1978, proposed regulations related to "invested sinking funds" appear to have been inspired by a large number of advance refunding issues using invested sinking funds coupled with so-called "forward supply contracts" guaranteeing the rate of return to be realized from the investment of taxes and other revenues deposited in a sinking fund. However, rather than limiting its proposals to the particular transactions which the Treasury had perceived as abuses, it subjected virtually all types of funds established in conjunction with municipal bond issues to potential review pursuant to the Federal arbitrage restrictions. Once again, the procrustean solution is far more serious than the "problem" the Treasury intended to resolve.

(c) The proposed revisions to the regulations scheduled to become effective September 1, 1978, would completely eliminate underwriting discount and issuance costs from the computations of yield on both governmental obligations and securities acquired with the proceeds of governmental obligations. In addition to the interpretative and administrative difficulties which such a prohibition will inevitably generate, this provision which purports to be directed to the elimination of abuses, once again goes far beyond what would be required to solve the "problem" perceived by the Treasury Department.

(3) In addition to the foregoing, there is a deep-rooted concern on the part of many persons that the various actions taken by the Treasury Department, and the decisions underlying these actions, have been made in a vacuum. The Treasury Department and the Internal Revenue Service have, over the years, become increasingly reluctant to discuss the proposed regulations with State or local governments or their representatives prior to promulgation. This has fostered the impression on the part of many—if not most—representatives of State or local government that the Treasury Department and the Internal Revenue Service either do not care about, or do not care to understand, the viewpoint of State or local governments. S. 3370 represents, in part, a reaction to this perception, since it would have the effect of affording State and local government representatives an opportunity to make their views known before the Congress—a part of the Federal Government which is willing to listen and understand the problems.

Given the foregoing, does it necessarily follow that S. 3370 should be enacted? The Treasury Department's representatives will argue that enactment of S. 3370 would not only unduly tie the Treasury's hands with respect to the interpretation and administration of Section 103(b) and (c), but would also lead to an immediate flood of invested sinking fund issues. Proponents of S. 3370 would reply that—had it not been for these proposed regulations—the bond issues which the Treasury is concerned about would have already been issued in the normal course of business: thus, any "flood" of municipal bond issues resultant upon S. 3370 is no more than a reaction to the Treasury's own activities to date.

It is my view that the answer to the question lies somewhere between these two extremes. For example, I could accept a decision that, a policy matter, certain types of advance refundings of pollution control issues are probably undesirable, and may fall within areas which, as a policy matter, the Treasury Department should be granted authority to restrict or eliminate under Section 103(b) of the Code. On the other hand, I feel strongly that other types of industrial advance refunding bond issues—such as those primarily for the purpose of realizing savings through lower interest costs; or for the purpose of debt restructuring or revision of bond convenants, ought to be free from Treasury Department restrictions. I would include in that category at a minimum the more publicity oriented industrial revenue bond issues such as airports. Whichever view one takes, however, the decision ought to be made only after a full exposition of views on all sides—not merely by administrative fiat, albeit only proposed but nevertheless final in practice despite pro forma hearings after the fact.

Similarly, while the Treasury believes that it has policy justification, for restricting the use of invested sinking funds in certain types of advance refunding transactions, I feel equally strongly that the Treasury currently lacks statutory authority to impose limitations in the case of municipal bond issues sold for purposes other than advance refundings. Unfortunately, the proposed regulations of May 8, 1978, fail to make a distinction between these two situations.

Finally, it is my personal belief that the Treasury already possesses sufficient authority under the pre-May 8, 1978, regulations to deal with the problem which the Treasury purports to perceive in the prior rules defining inflated or unreasonable costs associated with advance refunding transactions. To the extent that there is such a problem, it can be dealt with without the draconian measures slated to go into effect on September 1, 1978.

In conclusion, I would support a modified version of S. 3370.

The Treasury has perceived areas which it believed required regulation. State and local governments, with justification, perceive the Treasury's regulatory solutions as draconian and as upsetting the constitutional balance between Federal and state authority. Therefore, I would suggest the following:

(1) The proposed regulations of December 6, 1977, and May 8, 1978, be permitted to remain in effect until December 31, 1978, and that they would cease to be effective at that date unless Congress had specifically authorized the imposition of arbitrage yield restrictions in such cases—a sunset provision which would discipline the rulemaking process.

(2) The proposed regulations with respect to the treatment of administrative costs and bond discount associated with the computation of yield on the sale of municipal bonds would be suspended immediately.

(3) Any regulation (final or proposed) interpreting Section 103 (b) or (c) could under no circumstance be effective with respect to issues sold within 120 days following initial publication of the proposed regulation. This provision is essential if the public is to have an adequate opportunity to comment upon any proposed changes in the structure of the law and/or the regulations.

(4) State and local governments would be afforded the opportunity to secure judicial review of any adverse administrative determination with respect to the application of federal arbitrage law.

DETAILED DISCUSSION

S. 3370 is directed to both the proposed regulations of December 1, 1977, relating to advance refundings of industrial revenue bonds and of May 8, 1978, relating to "invested sinking funds", "administrative costs", and "certification procedures".

The proposed regulations of December 1, 1977, were promulgated by the Treasury Department in response to what was perceived by the Treasury to be an abuse of the authority granted by the Congress to utilize tax-exempt industrial bonds for certain specified private purposes which have public purpose. Thus, in restricting the use of tax-exempt industrial revenue bonds in 1968, Congress specifically authorized this type of financing for a variety of public-related activities carried out by private enterprise. For example, a tax-exempt financing was—and still is—authorized for the construction of residential housing, sports facilities, airports, docks and wharves, water and sewerage systems, solid waste disposal facilities, and facilities designed for the control and elimination of pollution.

In early 1977, a number of issuers of pollution control industrial revenue bond issues began to sell tax-exempt advance refunding bond issues for the purpose of either reducing the interest cost associated with the original sale of bonds; or for the purpose of extending the period of time over which the indebtedness with respect to the facility would be repaid. As the number of these issues began to increase through the summer and fall of 1977, the Treasury announced (on November 4, 1977) that it would soon issue regulations restricting the extent to which any previous issue of tax-exempt industrial revenue bonds could be refunded in advance of maturity. Subsequently, on December 1, 1977, these proposed regulations were published in the Federal Register. Not only did these proposed regulations impose restrictions on the advance refunding of pollution control facilities, but went on to limit the advance refunding of public facilities, technically characterized as industrial revenue bonds.

Following the publication of these proposed regulations, Treasury Department representatives acknowledged, both publicly and privately, that as a policy matter the restrictions imposed on advance refundings of such publicly-related facilities as airports, sports facilities, etc., was unjustified; and promised to cooperate with interested parties in securing appropriate remedial legislation from the Congress. As of today, neither corrective regulations, nor remedial legislation has been suggested by the Treasury Department, despite repeated requests from various affected issuers and representatives. Rather, it appears that the Treasury Department has made a conscious decision to avoid—as long as possible—any remedial action to permit any advance refunding of even the most publicly-related issues technically characterized as industrial revenue bonds.

S. 3370 is also directed to the more serious problems created by the Treasury Department in its proposed regulations of May 8, 1977, dealing with "invested sinking funds", and the treatment of discount and administrative costs for purposes of computing yield.

Since enactment of Section 601(a) of the Tax Reform Act of 1969, the arbitrage provisions of Section 103(c) have imposed limitations on the yield which can be earned from the investment of the "proceeds" from the issuance of tax-exempt municipal bonds. Simply put, Section 103(c) provides that if a municipality issues obligations whose yield is 6 percent per year, then the proceeds from the sale of those obligations may generally not be invested at a yield in excess of 6 percent (or, 6⅛ percent in certain circumstances). The specific statutory language imposing these restrictions is as follows:

> "(A) . . . The term 'arbitrage bonds' means any obligation which is issued as part of an issue, all or a major portion of the proceeds of which, are reasonably . . . expected to be used directly or indirectly . . . to acquire . . . obligations (which will) produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue, or
>
> (B) to replace funds which were used directly or indirectly to acquire obligations (bearing a materially higher yield)".

Throughout the series of temporary and proposed regulations published almost annually since 1969, it has been understood by virtually all students of the statute and its legislative history, that the phrase "proceeds" of municipal obligations meant exactly that, and no more. Thus, prior to the proposed regulations of May 8, 1978, the "proceeds" of an issue were defined to include the original proceeds from the sale of the bonds, together with any interest or dividends realized from the investment of those proceeds.

Since the federal arbitrage yield restrictions applied only to investments of proceeds of tax-exempt borrowing, they equally clearly did not apply to the investment of monies other than bonds proceeds, such as ad valorem taxes, general income tax collections, and general revenues from the operation of various types of municipal systems. Consequently, these monies could, under both the statute and the interpretation of the statute adopted by the Treasury Department since 1969, be invested in whatever securities were deemed advisable by the state or local government.

Since the investment of taxes and other operating revenues were not subject to federal arbitrage restrictions, a number of issuers began to structure their borrowings as long-term bond issues, accompanied by the required deposit into, and accumulation of, a sinking fund which would ultimately be applied to the repayment of the principal amount of the borrowing. Pending application to this purpose, the taxes and other revenues built up in the sinking fund could be invested by the municipality at whatever rate could be secured in the marketplace.

In its proposed regulations of May 8, 1978, the Treasury Department has attempted to limit the use of "invested sinking funds" by taking the extraordinary position that amounts accumulated in sinking funds to be applied toward the payment of debt service on a municipal bond will be "treated as proceeds." Thus, without further explanation, and without any attempt to justify the treatment of taxes and operating revenues as "proceeds" of a borrowing, the Treasury has simply proposed to do so.

Taxes and other revenues were clearly not "proceeds" when the statute was enacted in 1969; when the first temporary regulations were issued in 1970; when proposed regulations were issued and reissued in 1971, 1972, 1973, 1975, 1976 and 1977. It is only now, in 1978, that the Treasury Department has belatedly determined that it will attempt to subject taxes and other revenues to yield restrictions by "treating" them as proceeds.

It is difficult to discern the source of the Treasury's authority nine years after the enactment of Section 103(c), to reverse the long-standing interpretation and application of the concept of bond "proceeds".

One extraordinary result of this bureaucratic legerdemain is that the Treasury Department has now managed to double the total amount of dollars which may be subject to federal arbitrage yield restrictions for one bond issue. For example, if a city issues one million dollars of refunding revenue bonds, and accumulates one million dollars of tax collections toward the eventual retirement of that debt, the total dollars subject to federal arbitrage yield restrictions are suddenly increased to two million dollars:

--The one million dollars of proceeds generated from the sale of the municipal bonds, plus an additional one million dollars—representing the tax collections accumulated in a sinking fund.

Thus, a one million dollar bond issue can—under the Treasury Department's reasoning—result in two million dollars of either "proceeds" or "treated as proceeds", all of which are subject to investment restrictions.

The Treasury Department argues that the regulations of May 8, 1977, were necessitated by what they describe as a rash of tax-exempt advance of refunding bonds designed to utilize invested sinking fund financing. In order to cure this "abuse" the Treasury felt justified in defining taxes and other revenues as "proceeds" of a bond issue.

At the outset, of course, it is clear that not all parties would agree with the Treasury that the issuance of municipal bonds with invested sinking funds constitutes an "abuse". Certainly, for those states and local governments who realized substantial savings in long-term borrowing costs as a result of invested sinking fund financings, the technique can hardly be characterized as an "abuse". Similarly, those states and local governments who have been effectively prohibited from utilizing invested sinking funds since the publication of the May 8 proposed regulations, would rather characterize the Treasury's proposals themselves as the "abuse".

Presumably, the "abuse" to which the Treasury's proposals address themselves is the creation of tax-exempt advance refunding bonds in the marketplace, thus arguably increasing the amount of tax-exempt interest, and reducing federal revenues. One fallacy in this reasoning, of course, is the fact that under long-standing practices, all the proceeds of advance refunding bonds must be invested in direct obligations of the United States, bearing a yield no greater than the municipality's borrowing cost. In other words, if a municipality issues advance refunding bonds at 6½ percent, it must loan the proceeds of that borrowing to the federal government at 6½ percent. So, while the Treasury may arguably lose some tax revenue as a result of the duplicate issuance of tax-exempt bonds, that loss of revenue is largely—if not in some cases totally—offset by the reduction in the costs of the Treasury's own borrowings.

Furthermore, the Treasury's proposed regulations of May 8, 1978, are not limited to advance refunding bonds: they apply across-the-board to all types of municipal bond issues. Thus, in any case in which a state or local government plans to accumulate taxes or other revenues in a fund for the repayment of debt service, the Treasury Department has attempted to decree that the investment of monies in that fund be limited by reference to the yield on the bonds themselves. There is no question, in these cases, of a double series of bonds being outstanding. What is at issue in these cases is a bald attempt by the Treasury Department to further restrict the flexibility of state and local governments in structuring their own long-term financings.

Finally, because of the broad sweep of the proposed regulations of May 8, 1978, the Treasury Department has succeeded in extending the scope of the federal arbitrage regulations to virtually every issuer—and virtually every issue—of tax-exempt bonds in the United States.

Given the extensive impact and implications of these proposed regulations on state and local government, did the Congress consider the problem of invested sinking funds? No.

Did the Treasury hold public hearings on the general subject and invite views from affected parties before attempting to act? No.

Did the Treasury afford state and local governments and their representatives an opportunity to comment upon the proposed regulations before they were made effective? No.[2]

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[2] In a press release issued on May 3, 1978, the Treasury Department proclaimed that it would publish proposed regulations dealing with invested sinking funds in the Federal Register on May 8, 1978. When those proposed regulations were published, they provided that they would be effective with respect to any bond issues sold after May 15, 1978, provided that the issuance of the bonds had been authorized or otherwise undertaken prior to May 3, 1978. In other words, at the time that the Treasury Department first publicly expressed any views with respect to invested sinking funds, they had already effectively eliminated that format of financing.

The proposed regulations of May 8, 1978, have another extraordinary provision related to the method of computing yield on tax-exempt bonds. As noted above, Section 103(c)(2) describes an arbitrage bond in terms of the relationship between the yield on the obligations issued by the state or local government, and the yield realized with respect to obligations acquired with the proceeds of those bonds, in each case ". . . taking into account any discount or premium . . ."

At the time the statute was drafted, and through each successive set of proposed regulations, it has been clearly understood that the statute means exactly what it says, and that the computation of yield would take into account any discount or premium with respect to the sale of municipal bonds or the acquisition of acquired obligations from the proceeds of those bonds. Thus, if a state offers to sell ten million dollars worth of its bonds to the person presenting the best bid, that bond issue will be sold to the bidder who offers coupons, and a purchase price, which produces the lowest net interest cost to the issuer, over the life of the issue. If the issuer of those bonds receives $9,850,000 as the purchase price for $10,000,000 principal amount of bonds, the discount of $150,000 represents a cost for the use of money which must be repaid over time. Characterization of that discount as part of the borrowing cost, and as part of the yield on bonds, is so well-settled, both as matter of state law and federal income tax law, that it need not be elaborated on further.

Nevertheless, the Treasury Department once again decided to ignore the specific language of the statute, and provided in its proposed regulations of May 8, 1977, that with respect to any issue, delivered after September 1, 1978, the discount or premium with respect to bonds sold by a municipality shall be disregarded to the extent that is realized by an underwriter, broker, or "other intermediary".

This is just plain wrong. It is wrong as a matter of law. It is wrong as a matter of economics. It is wrong as a matter of common sense.

The Treasury seems to argue that since the initial purchaser of most municipal bonds will resell them to other investors, that that initial purchaser is somehow not relevant to the transaction. Nothing, of course, could be further from the truth. An underwriter who purchases an issue of municipal bonds does so pursuant to a fixed contract, which establishes the fixed amount of the bonds, the fixed maturities for the bonds, and the purchase price which will be paid for the bonds, together with a "good faith" deposit typically paid to the issuer substantially in advance of the settlement of the transaction. Thus, at the time the purchase contract is signed, the underwriter is specifically committed to purchase, as a principal, the amount of bonds represented in the purchase contract. He may resell those bonds. He may not. He may sell them for a profit; or he may sell them at a loss. All of that, of course, is totally irrelevant to the issuer of the bonds. The terms for the sale of the bonds are established by the contract between the issuer of the bonds and the initial purchaser of the bonds, and that—and that alone—should be determinative of the yield or cost of money.

The Treasury Department attempts to justify the broad sweep of its proposd regulations by reference to Section 103(c)(6), pursuant to which Congress—in 1969—provided that:

> The secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this Subsection.

The Treasury Department argues that this delegation of rulemaking power is broad enough to permit the Treasury to limit, prohibit, outlaw, or otherwise regulate, any financial practice on the part of state or local governments which the Treausry Department—alone, in its own isolated wisdom—determines to be inconsistent with "the purposes" of Section 103(c). I submit that such a sweeping interpretation of the rulemaking authority delegated to the Treasury Department in Section 103(c)(6) makes the balance of the statute absolutely meaningless. In fact, a briew review of the legislative history connected with Section 103(c) shows the utter poverty of the Treasury's position on this point.

Section 601(b) of the House-passed version of the Tax Reform Act of 1969 provided, simply, that "under regulations prescribed by the Secretary of the Treasury or his delegate", an arbitrage obligation would not be tax-exempt. In response to this broad proposal, the Treasury Department itself requested the Senate Finance Committee to provide a standard by which the proscriptions against arbitrage bonds could be measured. In the statement of the Treasury's position on the Tax Reform Act, the following appears:

"Treasury supports the objective of the bill to deny tax-exempt status to state and local bonds issued in a true arbitrage transaction. However, Treasury recommends that the bill be amended to provide a rule which may be amended to provide a rule which may be easily understood and applied and which furnishes a clearer standard to be followed in the regulations. Treasury proposes that an obligation be considered an "arbitrage obligation" if, under regulations prescribed by the Secretary or his delegate, the circumstances (including but not limited to the terms of the obligation, the specified purpose of the issue, the nature of the security provided for the obligation, and all other relevant facts) demonstrate that the result of the issuance is the realization of an arbitrage profit from reinvestment of the proceeds in higher yield securities . . .".

Thus, the Treasury Department, which had initiated the legislation in 1969, itself had requested a statutory standard to be interpreted by the Secretary of the Treasury; and also clearly contemplated arbitrage restrictions only with respect to the proceeds of bonds themselves.

The Senate Finance Committee went even further than the Treasury's request in this regard. The Senate Finance Committee's version of the arbitrage statute, as essentially endorsed by the Conference Committee and enacted into law, provided a quite specific definition of an arbitrage bond, modeled closely upon the definition proposed in earlier legislation introduced by Senator Ribicoff and Representative Burns in 1967.

A complete legislative history of the arbitrage provisions of Section 103 (c) is attached to this Statement.

Thus, it is quite clear that in carrying out its responsibilities to prescribe regulations under Section 103(c) the Treasury Department is at the same time constrained by the provisions of Section 103(c). In other words, "the purposes of this Subsection" must be those which are set forth in the Subsection; and cannot be those which the Treasury Department—nine years later—decides to attribute to the authors of the Statute.

Given the structure of the statute, and given its legislative history, does the Treasury have the authority under the law to prescribe regulations whose effect is to impose investment restrictions upon taxes and other revenues of state and local governments? Clearly not. Both the legislative history of Section 103(c), and consistent interpretations of that statute over the past nine years, make it clear that Congress was dealing with what it perceived to be a specific abuse of tax-exempt bond financing. That abuse, carefully set forth in the legislative history, related to the investment of the direct proceeds of bond issues at investment yields materially higher than the yield on the bonds themselves. Congress did not anticipate that Section 103(c) could be utilized as a means to subject normal operating taxes and other revenues to yield restrictions based upon the borrowing costs of state and local governments.

EXHIBIT A

C. Willis Ritter, born Baltimore, Maryland, February 18, 1940; admitted to bar, 1965, Maryland; 1966, U.S. Court of Appeals, Fourth and Fifth Circuits and U.S. Tax Court; 1968, U.S. Court of Claims; 1969, U.S. Supreme Court; 1972, District of Columbia. Preparatory education, Cornell University (A.B., 1962); legal education, University of Virginia (J.D., 1965). Member, Editorial Board, University of Virginia Law Review, 1963–1965. Law Clerk to Judge Simon E. Sobeloff, U.S. Court of Appeals, Fourth Circuit, 1965–1966. Attorney Advisor, Office of Tax Legislative Counsel, U.S. Treasury Department, 1969–1972. Co-Author "Gifts in Contemplation of Death," 182 *Tax Management*, 1968, with Jacques T. Schlenger; "Real Estate and Tax Reform," *University of Maryland Law Review*, Winter, 1971, with Emil Sunley, Author: "Arbitrage Bonds," 271 *Tax Management*, 1972; "Advance Refunding of Municipal Indebtedness," *The Urban Lawyer*, Vol. 9, No. 2 (Spring 1977); Co-Author: "Federal Arbitrage Law and Advance Refunding of Municipal Indebtedness," — *Tax Management* (1978), with David L. Miller, *Member*: The District of Columbia Bar; Bar Association of the District of Columbia; American Bar Association (Member: Section on Taxation; Committee on Tax-Exempt Financing, 1977——; Chairman, Subcommittee on Arbitrage, 1978; National Bond Attorneys' Workshop (Member: Steering Committee, 1975——; Chairman, 1978–1979).

EXHIBIT B

LEGISLATIVE HISTORY

TIR-840

(August 11, 1966)

The U.S. Internal Revenue Service today announced details of its policy of *declining* to issue rulings that the interest on certain obligations is exempt from Federal income taxation under Section 103 of the Internal Revenue Code of 1954.

The policy will continue in effect, uending the conclusion of a study to determine whether such obligations should be considered obligations of States, Territories, possessions, their political subdivisions or the District of Columbia. The study will be directed at obligations issued by these governmental units where a principal purpose is to invest the proceeds of the tax-exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield. The profit received by the governmental units on the differences between the interest paid on the exempt obligations and the interest earned on the taxable obligations is in the nature of arbitrage. The study will not affect obligations issued prior to the date of this release.

More specifically, this ruling policy will apply to obligations falling within either of the following two categories:

1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.

2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded.

The following are *examples* of transactions with respect to which no ruling will issued:

First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.

Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.

Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During the interim period, arbitrage profits based on the interest spread inure to the municipality.

The Service made clear that this announcement covers only obligations falling within the two categories described above. Thus, for example, it does not cover an issue of obligations where the proceeds are intended to be used to construct a facility even though the proceeds are initially placed in a trust for the security of the bond holders, and invested in taxable obligations, pending their use to meet the construction costs as they occur. Nor does it cover an issue of obligations merely because a portion of the proceeds is invested in taxable obligations and held solely to meet interest payments on the obligations pending, the availability of other revenues.

STATEMENT AND PROPOSAL OF REP. JOHN BYRNES RELATING TO ARBITAGE BONDS JULY 25, 1967)

AND

STATEMENT AND PROPOSAL OF SENATOR ABRAHAM RIBICOFF RELATING TO ARBITRAGE BONDS (NOVEMBER 8, 1967)

REPRESENTATIVE JOHN BYRNES

LEGISLATION TO TAX INTEREST FROM ARBITRAGE BONDS

Mr. WYATT. Mr. Speaker, I ask unanimous consent that the gentleman from Oregon [Mr. BYRNES] may extend his remarks at this point in the Record and include extraneous matter.

The SPEAKER. Is there objection to the request of the gentleman from Oregon?

There was no objection.

Mr. BYRNES of Wisconsin. Mr. Speaker, I have already introduced a bill to amend section 103 of the Internal Revenue Code in order to take away the tax exemption presently enjoyed by the so-called industrial development bonds. I have today introduced another bill dealing with the arbitrage bond. The problem is similar to that presented by the industrial development bond.

My bill would amend section 103 of the Internal Revenue Code in order to exclude from the exemption granted to State and municipal obligations, those bonds which are issued for the purpose of investing the proceeds in U.S. Treasury obligations bearing a higher rate of interest. This is known in the trade as "arbitrage."

The mechanics of an arbitrage bond are simple. A State or local government issues bonds and agrees to invest the proceeds in Federal bonds which are then placed in escrow for the payment of interest and principal on the State or local bonds. The investor in these bonds has a certificate which represents neither more or less than interest in Federal bonds, but because the interest payments made by the Federal Government pass through the hands of the State or local government it is argued that the interest is exempt. The local government thus makes a profit from the interest differential that exists between the taxable Federal securities and the nontaxable securities which it purports to issue.

Last year the Treasury Department announced that the Internal Revenue announced that the Internal Revenue Service would not rule on extending the interest exemption to arbitrage transactions under existing law. I am convinced that this action is correct. Arbitrage bonds really represent an agreement by the issuer to act as a conduit or trustee for passing interest on Federal bonds to private persons and they are not "obligations" of a State or local government within the meaning of existing law. While the Treasury Department is considering further guidelines to implement the arbitrage ruling, to avoid any misunderstanding in this area, I have introduced a bill to make it doubly clear that the interest in arbitrage bonds is not entitled to exemption from Federal income tax.

I am inserting a copy of my bill together with a technical explanation at this point in the Record:

H.R. 11757

A bill to amend the Internal Revenue Code of 1954 to provide that arbitrage bonds are not to be considered obligations of States and local governments the interest on which is exempt from Federal income tax

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 103 of the Internal Revenue Code of 1954 (relating to interest on certain governmental obligations) is amended by relettering subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ARBITRAGE BONDS.—

"(1) Subsection (a)(1) not to apply.—Any arbitrage bond (as defined in paragraph (2)) shall not be considered an obligation described in subsection (a)(1)

"(2) 'ARBITRAGE BOND' DEFINED.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'arbitrage bond' means any obligation if, under the terms of the obligation or any underlying agreement, any portion of the proceeds of the issue of which the obligation is a part may be invested, directly or indirectly, in any securities (other than obligations the interest on which is excluded from gross income under subsection (a) after the application of this subsection) which yield a higher return (taking into account any discount or any premium) than the obligation being issued, and such securities are required to be held as security for any obligations the interest on which is excluded from gross income under subsection (a) before the application of this subsection.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to an obligation—

"(i) if under the terms of the obligation or underlying agreement all of such securities (other than those described in (ii) and (iii) below) in which the proceeds may be invested may not be held longer than two years from the date of the issuance of the obligations;

"(ii) if the obligation or an underlying agreement limits the amount of the proceeds which may be invested in such securities as of the beginning of any annual accounting period provided for in the obligation or underlying agreement to not more than the amount of interest and principal payments required to be made with respect to such obligation within such annual accounting period and the accounting period following such annual accounting period;

"(iii) to the extent that the proceeds of such obligation are to be used to construct a facility the actual construction of which (other than acquisition of land) must commence within two years from the date of such issuance if under the terms of the obligation or underlying agreement the portion of the proceeds to be used in connection with such construction may not be invested in such securities for a peirod in excess of five years from the issuance of such obligation.

"(3) SPECIAL SERIES OF OBLIGATIONS.—At the request of an organization described in subsection (a)(1), the Secretary is authorized under the Second Liberty Bond Act, as amended (31 U.S.C., sec. 752 and following) to provide for the issuance of a special series of obligations of the United States the yields on which shall not exceed the yields on obligations described in paragraph (2).

"(b) The amendment made by subsection (a) shall apply only with respect to interest on bonds issued after the date of the enactment of this Act."

TECHNICAL EXPLANATION OF PROPOSED AMENDMENT TO SECTION 103 OF THE INTERNAL REVENUE CODE OF 1954 RELATION TO ARBITRAGE BONDS

The proposed bill amends section 103 of the Internal Revenue Code by adding new subsection (c), Paragraph (1) of subsection (c) provides that an arbitrage bond shall not be considered an obligation of a State or local government the interest on which is exempt from tax.

Paragraph (1) of new subsection (c) defines the term "arbitrage bonds." Subparagraph (A) provides that a bond will only be considered an arbitrage bond (1) if under the terms of the issue, the State or local government may invest the proceeds of the issue in taxable obligations yielding a higher rate of interest than the issue in question, and (2) if the portion of the proceeds so invested is required to be held as security for the payment of the issue in question or any other bond issue the interest payments on which are exempt from Federal income tax.

This definition and the several exceptions discussed below have been drafted in a manner that will permit a prospective purchaser to determine from the terms of the obligation and underlying agreement that a given obligation is not an arbitrage bond. By the same token an issuing governmental unit, by carefully drafting the bond agreement, can insure that a bond will not come within the definition of an arbitrage bond. This aspect of the bill as well as the exceptions contained in subparagraph (B) will allow State and local governments unfettered freedom to engage in any financing arrangement necessary to achieve the basic purpose of a particular bond issue. Subparagraph (B) excludes from the definition of an arbitrage bond certain common situations which may require a limited investment of the proceeds in taxable securities and it is anticipated that these exceptions will render the bill inapplicable to the vast majority of governmental bond issues. It is also recognized, however, that certain abnormal situations may prompt the issuance of bonds which require an investment exceeding the specified limitations.

A municipality, confronted with such an abnormal situation, may avoid the provisions of the bill if it confines any investment exceeding the specified limits to securities which do not yield a higher rate of interest than the bonds being issued. Paragraph (3) of the new subsection (c) authorizes the Secretary of the Treasury to provide for the issuance of special federal obligations which will meet this requirement for municipalities which are unable to purchase bonds yielding the same or a lower interest rate as the issue in question on the open market.

For example, municipalities often find it desirable to engage in advance refunding transactions in order to insure an orderly transition between an outstanding issue approaching maturity and a new issue which is to replace the maturing bonds. The municipality will invest the proceeds of the new issue in securities to be held in escrow for the benefit of the outstanding bonds. Subparagraph (B)(i) of the new subsection (c)(3) provides a general two year exception which would exclude advance refunding issues from the definition of an arbitrage bond if the proceeds could not be invested in higher yield taxable securities for longer than two years. The two year limitation contains the investment profit within tolerable limits and insures that any profit that results is primarily a by-product of the transaction rather than its essential purpose.

On the other hand, in certain unusual cases it may be desirable to invest the proceeds of an advance refunding issue for a period exceeding two years. An oft cited example involves revenue bonds which were issued to build a bridge and which contain a restrictive covenant prohibiting the erection of a second bridge in the same area. A municipality may engage in an advance refunding transaction in order to secure a release from the restrictive covenant and simultaneously raise revenues to build a second bridge. If the portion of the proceeds which are to be held in escrow for the outstanding bonds are to be held for a period in excess of two years (because the outstanding bonds are not callable) the newly issued bonds will constitute arbitrage bonds under the bill unless the municipality also agrees that the proceeds will not be invested in bonds yielding a higher rate of interest than the advance refunding bonds once the two year period is past. If it is necessary, to comply with such an agreement, the municipality may request the Secretary of the Treasury to issue a special series of federal bonds whose yields will not exceed the interest on the advance refunding issue. In this way the bill provides maximum flexibility for all state and local government financing needs while limiting the amount of unjustified profit that may be realized through arbitrage trading on the interest differential between taxable and nontaxable obligations.

In addition to a general two year exception, subparagraph (B)(ii) permits a State or local government to set aside out of the proceeds of a new issue and invest an amount equal to that needed to pay the interest and principal (if any) during a two year period after the date of issue of the obligation. The fund so set aside and invested as a debt service reserve must be reduced in future years as bonds are paid off and the interest and principal requirements ~~needed to meet~~ payments during successive two year periods becomes smaller. Part (iii) of subparagraph (B) provides an additional exception for bonds issued to construct new facilities. Under that provision, if construction is to commence within one year of the bond issue, the proceeds borrowed to permit construction may be invested in taxable obligations yielding a higher return for up to five years from the date of the bond issue.

As in the case of the advance refunding bonds, if a municipality finds it necessary to have a larger debt service reserve or to have a longer construction reserve, the bonds will not constitute arbitrage bonds if the municipality confines the investment which exceeds the specified amount or period to securities which do not yield a higher rate of interest than the interest called for by the bonds in question.

SENATOR ABRAHAM RIBICOFF

PROPOSED LEGISLATION RELATING TO AMENDMENT OF INTERNAL REVENUE CODE

Mr. RIBICOFF. Mr. President, I introduce for appropriate reference, a bill to amend the Internal Revenue Code of 1954 to provide that industrial development bonds are not to be considered obligations of States and local governments, the interest on which is exempt from Federal income tax, and a bill to amend the Internal Revenue Code to provide that arbitrage bonds are not to be considered obligations of States and local governments, the interest on which is exempt from Federal income tax.

Mr. President, for over 50 years our State and local governments have benefited in financing their governmental functions from the Federal income tax exemption of the interest on their bonds. Because of this exemption investors have been willing to accept a lower rate of interest on school bonds, water and sewer bonds, and other similar State and local obligations, than they would demand if, like the bonds of the Federal Government, our State and local bonds were fully subject to Federal income tax.

However, recent abuses of the tax-exempt borrowing privilege are undermining the usefulness of this method of helping our State and local governments finance their legitimate functions at the lowest possible cost. These abuses, which are becoming more prevalent every day, represent an intolerable waste of our Federal tax dollars and a real and immediate threat to the ability of our State expanding obligations.

The most widespread and well-known abuse of the tax-exempt borrowing privilege is the practice of issuing so-called industrial development bonds. These bonds have permitted some of our largest corporations to issue tax-exempt bonds to the detriment of the best interest of both the Federal Government and the State and local governments.

A typical case might involve a municipality which agrees to issue bonds to finance the building of a factory for a private corporation. The corporation in turn agrees to "rent" the factory for the exact amount needed to pay the interest and amortize the principal of the bonds. The bonds are generally revenue bonds payable only out of the rent and the municipality assumes no obligation, direct or indirect, for repayment of either principal or interest on the bonds. Thus, we are really confronted with bonds of a private corporation. But, because the municipality allows its name to appear on the bonds, it claims and passes on to the private corporation the full benefit of the lower interest rate. This rate stems from the Federal tax exemption of interest on legitimate State and local bonds.

These are truly corporate bonds and the local government's involvement is often little more than a sham. This was graphically demonstrated last year. The 35 eligible voters of one small town were asked to approve a bond issue of $20 million in order to finance a plant for a prominent textile company. Indeed, the largest industrial bond issue ever announced, $140 million for a Japanese aluminum company, is to be issued by Port of Astoria, Oreg.—a town of less than 30,000 people.

The Federal Government's concern is obvious. The benefits received by the private corporation in the form of lower rental payments represent nothing more than an unauthorized Federal subsidy to private industry. The total cost of this subsidy—which is exclusively attributable to the interest exemption intended to help our State and local governments—is borne by other Federal taxpayers. However, viewed as a subsidy, industrial development bonds are totally unjustified. The benefit of such financing frequently goes to private corporations who do nothing different than they would have done without the use of industrial development bonds and in all cases the cost of the Federal Government in lost tax revenues considerably exceeds the financial benefits to the private corporations involved.

Unlike most Federal programs, the Federal expenditure is not a part of the Federal budget, was never passed on by Congress, and is not even subject to review by a Federal agency. The sole decision as to whether a private corporation shall receive the benefits of tax-exempt finance depends upon whether a local government will permit the use of its name on what are in reality corporate bonds. Moreover, because an agreement to permit the use of its name costs a governmental unit nothing, there is no apparent reason why any governmental unit would withhold its approval of any particular bond issue and of any subsidy.

However, the problem presented by industrial development bonds today is far more than just a problem of wasted Federal revenues. It has become a very serious problem for our State and local governments themselves. The benefit our State and local governments receive by the exemption of the interest on their bonds is dependent on the fact that tax exempt bonds are a unique exception and that most bonds—both corporate and Federal—are fully subject to Federal income tax. As more and more tax-exempt bonds are issued the interest rate on all tax-exempt bonds, including school bonds, water and sewer bonds, will increase in order to make the total supply of exempt bonds attractive to lower bracket taxpayers. Thus, the cost of local government goes up.

Moreover, in recent years some of the largest industrial corporations in the Nation have used industrial development bonds and many of our smaller State and local governments increasingly find themselves handicapped when they are forced to compete for funds in the same limited market against these corporate giants.

For example, in recent years bonds have been issued or announced on behalf of Armco Steel Corp., Firestone Tire & Rubber Co., Litton Industries, Sinclair Oil, and United Fruit Co. The entry of many of our most prominent corporations into the tax-exempt bond market is also reflected by the dramatic increase in the average size of new public issues in recent years as well as in the geometric growth rate of the total of new issues.

In view of this situation one might well ask why our State and local governments continue to tolerate this abuse of a provision which was desigend to help them meet their legitimate needs. The answer is that historically these bonds developed in such a manner that today, even though they pose a serious threat to the borrowing ability of our State and local governments, those same State and local governments are virtually powerless to stop them.

This type of financing was originally developed in 1936 in order to attract relatively small industrial concerns to rural areas. Even as late as 1960 only 13 States authorized industrial development bonds and the data available with respect to public issues in that year indicates that only $70 million in such bonds were issued. However, as interest rates rose States that did not authorize this form of financing found themselves at a handicap in retaining or attracting industry and were forced to authorize industrial development bonds as a competitive measure.

Today over 40 States sanction some form of this abuse and new public issues this year are expected to involve over $1 billion. In addition to private placement of such bonds, as to which no reliable date is available, may involve more than twice the amount of publicly sold issues this year.

Connecticut does not authorize industrial development bonds. As a consequence we have seen corporations which by all logic should have built new plants or expanded existing facilities in Connecticut lured to other areas.

The officials in my State recognize that industrial development bonds are a costly abuse of the tax exemption. It is an abuse that runs directly counter to the best interests of all the States in this country. Yet unless some meaningful action is taken soon, Connecticut will probably be forced, as a matter of self defense, to join the other States in authorizing and perpetuating this waste of Federal and local resources.

These facts explain the dilemma confronting all our State and local governments today. On one hand, since a corporation seeking tax-exempt financing has over 40 State to choose from, it is clear that industrial development bonds no longer serve as a method of of attracting industry to any particular State. On the other hand, since an agreement by a State or local government to allow a private corporation to use its tax-exempt borrowing privilege costs the State or local government nothing, no governmental unit can afford by itself to end this abuse in its area for fear of losing industry to another locality.

This means that the use of industrial development bonds will continue to grow even though they have lost their advantage to the issuing State and local governments and have in fact become a detriment by driving up the interest costs for providing legitimate State and local services.

Thus we are confronted with the type of ludicrous situation which recently led one State to enact a law authorizing industrial development bonds throughout the State and simultaneously pass a resolution calling upon the Federal Government to deny the tax-exempt status of interest on industrial development bonds.

The rapid increase in industrial development bonds is today reaching crisis proportions. Occurring as it does at a time when our State and local governments are confronted with larger and larger demands to provide services and facilities for their citizens and when our Federal Government is confronted with an ever-increasing need for revenue, the use of industrial development bonds has presented us with a situation that can no longer be tolerated.

The Federal Government and the States must join together in eliminating this situation which threatens to undermine their own best interest. And because no State can be expected to end industrial development financing on its own while other States continue to permit such financing, the responsibility for action lies with Congress as the only body with power to enact legislation that can be uniform and simultaneous throughout the 50 States.

In addition to industrial development bonds, another abuse of the tax exemption afforded State and local bonds has gained prominence within the last few years. I am referring to the so-called arbitrage bonds where a local government invests the proceeds of its tax exempt issue in U.S. bonds which in turn secure the bonds issued. In effect the investor has a certificate evidencing an interest in Federal bonds, but the suggestion is made that the interest received is exempt because the funds pass through the hands of a local government unit.

The local government seeks to make a profit from the difference in interest rates that would arise, since interest on Federal bonds is taxable and the interest paid by the local government is claimed to be exempt. And this profit is claimed on the sole ground that the local government lends its name to a security—without assuming any risk, or responsibility, or work, or anything else.

It takes but little imagination to see that the unchecked spread of arbitrage bonds would pose as great a threat to the Federal revenues and the financing costs of State and local governments as industrial development bonds. From the investors standpoint arbitrage bonds are as secure as Federal bonds and any municipality in the country, no matter how small, could issue unlimited amounts of arbitrage bonds.

In theory the only limit on the amount of arbitrage bonds that could be added to the normal volume of tax-exempt bonds is determined by the amount of Federal obligations that are outstanding. However, the existence of arbitrage bonds on any sizable scale would drastically increase the cost of State and local government borrowings to finance legitimate governmental functions.

Last year the Internal Revenue Service announced that it would not rule on extending the interest exempt to arbitrage transactions under existing law. I am convinced that this action was correct. In essence, the issuing government which engages in an arbitrage transaction is nothing more than a trustee for the bondbuyers who are purchasing—not the obligations of a State or local government—but the obligation of the Federal Government.

I fail to see how an agreement by a locality to act as a conduit for passing interest on Federal bonds to private individuals can be considered the type of "obligation" of a State arising from the exercise of its borrowing power that is encompassed by existing law. To extend the interest exemption to these bonds seems to be outside both the purpose and the literal language of the law which exempts interests on obligations of a State or local government from tax but does not exempt interest on Federal bonds from tax.

A pertinent point here is that this same rationale also casts doubt on the validity of exempting the interest on industrial development bonds.

An examination of most industrial development issues makes it clear that the only real obligor is the private company for whose benefit the bonds are issued. However, the Internal Revenue Service has, for many years, been issuing rulings holding interest on these bonds tax exempt. That position was adopted when the magnitude of these offerings was small and the problems which now loom so clearly were difficult to perceive. I am sure that if the clock were set back the Service would, knowing what it now knows, rule differently.

On the other hand, facing the industrial development situation as it now exists, I feel a legislative solution to this facet of the problem is preferable to administrative action.

To this end, I am introducing a bill which will put a stop to the costly and self-defeating situation which the proliferation of industrial development bonds has brought about. In addition, even though I believe the Treasury Department's position on arbitrage bonds is correct under existing law, to avoid any misunderstandings I am also introducing a separate bill on this subject.

Mr. President, I ask unanimous consent that there be printed in the Record at this point a memorandum on trends in industrial bond financing prepared by the Treasury Department, followed by a letter and material from the Investment Bankers Association of America, a statement by the AFL-CIO executive council, and the text of the bills with a technical explanation of each.

The Acting President pro tempore. The bills will be received and appropriately referred; and, without objection, the memorandum, letter, material, statement, bills, and technical explanations will be printed in the Record.

The items presented by Mr. Ribicoff are as follows:

Trends in Industrial Development Bond Financing

Generally, each industrial development bond issued by a governmental unit serves to finance a single project for a specific corporation. It is therefore possible to discern a trend in the size of firms acquiring facilities financed by these tax-exempt bonds by examining the changes in the average value of industrial development bond issues.

Prior to 1960, the estimated total value of industrial development bond debt outstanding was just about $100 million. In the seven years 1960–66, the dollar value of new industrial development bonds increased by an estimated $1.2 billion.[1] This absolute growth in the volume of industrial development bonds issued since 1960 is partly explained by the increase in the number of states permitting local units to borrow for this purpose. However, the increase in the number of states authorizing industrial development bonds has coincided with a marked rise in the size of projects financed.

Table I shows the estimated value of publicly issued industrial development bonds for the years 1956–66, the number of issues and the average amounts borrowed to finance projects in each year. The regular of projects in each year is approximately equivalent to the number of issues shown in Column 2. Between 1956–60, 217 projects were financed and the average issue size ranged between $267,541–$742,797. Since 1961, the average amounts borrowed to finance industrial projects has ranged between $1.0–$3.0 million.

The growth in average value of projects financed since 1961, is due to the sharp increase in the number of large-scale projects financed, that is, projects in excess of $1 million. In Table 2, the number of issues exceeding $1 million since 1956 is shown. Prior to 1961, the largest industrial development bond issue was $9.5 million; however, between 1961–66, 19 single issues in excess of $20.0 million were floated. In 1956 alone the 8 largest issue accounted for $334 million,[2] more than 60 percent of the estimated $500 million in new public issues for that year. Finally, the preliminary 1967 data involving large issues set forth in Table III reveals that new public issues this year can be expected to substantially exceed $1 billion.

TABLE 1.—ESTIMATED VALUE OF PUBLICLY ISSUED INDUSTRIAL DEVELOPMENT BONDS[1] BY LOCAL UNITS, NUMBER OF ISSUES REPORTED, AND AVERAGE ISSUE SIZE, 1956–66

Year	Total amount of bonds issued (thousands)	Number of issues	Average size of issue
1956	$6,421	24	267,541
1957	7,328	22	346,000
1958	12,746	47	271,000
1959	22,096	50	458,920
1960	56,383	74	742,797
1961	57,201	42	1,361,900
1962	77,877	64	1,216,800
1963	135,225	67	2,018,300
1964	201,571	82	2,458,200
1965	191,717	78	2,457,900
1966	504,460	133	3,792,932

[1] See, e.g., Fridges, "State and Local Inducements for Industry," 18 National Tax Journal, 7. 8(1965).

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[1] The material discussed in this memorandum is drawn primarily from data involving publicly offered industrial development bonds. In addition, there is a large volume of privately placed industrial development bonds which are not reflected in the above estimates. Commentators have estimated that the actual amount of industrial development bonds outstanding may be two to three times larger than estimates based on public offerings would indicate. See, *e.g.*, Bridges, *State & Local Inducements for Industry*, 18 National Tax Journal 7.8 (1965).

[2] The eight issues were: $60 million issued for Skelly Oil and American Can Co., $70 million for United Fruit Co., $35 million for Phoenix Steel Corp., $34.4 million for Armco Steel Corp., $46 million for Nookosa-Edwards Corp., $24 million for Air Reduction Co., and $27 million for Hercules Corp.

TABLE II.—*Number of industrial development bonds issued in excess of $1 million, 1956–66*

Year:	Number
1956	1
1957	1
1958	2
1959	1
1960	9
1961	5
1962	14
1963	16
1964	25
1965	23
1966	46

TABLE III.—INDUSTRIAL DEVELOPMENT BOND TRANSACTIONS EITHER PENDING OR COMPLETED IN 1957 (LARGE ISSUES ONLY)

Corporation	Municipality	Amount (millions)
Armco Steel	Middletown, Ohio	$82.5
Sinclair Petro-chemicals (subsidiary of Sinclair Oil)	Fort Madison, Iowa	60.0
Firestone Tire	Warren City, Ky	30.0
West Virginia Pulp and Paper	Wickliffe, Ky	80.0
Allied Supermarkets	Livonia, Mich	33.0
Georgia-Pacific	Crossett, Ark	75.0
Wyco-Chemical	Cheyenne, Wyo	20.0
Minnesota Mining	Nevada, Mo	25.0
Southwire Co	Hancock City, Ky	90.0
Northwest Aluminum (subsidiary of Bell Intercontinental. Leases granted by Bell Intercontinental and Yawata Iron & Steel Co. of Japan)	Warrenton, Oreg	140.0
Union Indactrine (Shipbuildeing)	Paacagoula, Miss	130.0
Hytran ———, Inc. (partially owned by Hercules, Inc. and Earthenworks Hoochal A.G. of Frankfort, West Germany).	Spartanburg City, S.C	75.0
General Dynamics Shipyards	Quincy, Mass	100.0
U.S. Plywocd-Champion	Copeland, Ala	100.0
Boise-Cascade	De Ritter, La	110.0
Swiss Aluminum Ltd	Calcasieu Parish, La	75.0
Hercules	do	[1] 30.0
Do	Iberville Parish, La	[1] 30.0
Copolymer	West Baton Rouge Parish, La	20.0
Meade Corp	Michigan	60.0
Minnesota Mining	Weatherford, Okla	10.0
Ibgals Shipyard (Litton Industries)	Lorain, Ohio	30.0
Frontier Refining	Cheyenne, Wyo,	25.0
Allied Chemical	Green River, Wyo	20.0
Carrier Corp	Warren City, Tenn	12.5
Olin Mathieson	Bradley City, Tenn	12.0
Total		1,475.0

[1] $5,000,000 authorized.

INVESTMENT BANKERS
ASSOCIATION OF AMERICA,
Washington, D.C., October 6, 1967.

Hon. ABRAHAM RIBICOFF,
Senate Office Building,
Washington, D.C.

DEAR SENATOR RIBICOFF: The Investment Bankers Association of America appreciates your continued interest and concern with the increased use of municipal tax exempt credit by corporations for their own private use, a practice referred to as municipal industrial financing. This practice is increasing at an extremely fast rate with prospects of over a billion dollars of new securities for this year. There is no question in the minds of many market experts that this increased volume is costing municipalities throughout the country higher interest rates. For example, it has been estimated by some investment bankers that the recent $55 million Fairfax County Water Authority Bonds were forced to carry ¼ to ⅜% higher interest rate because they sold during the same week that the Georgia Pacific Corporation sold $75 million tax-exempt securities under the name of Crossett, Arkansas at 5⅝%. Over the life of a bond issue of this size, it would cost the residents of Fairfax County approximately $4 million in excess interest charges.

The enclosed material shows the list of some of the issues coming to sale and one of which would be of particular interest to you is that of Hegeman Electric Co. of Hartford, Connecticut for expansion in Florence, Kentucky.

The members of our Association hope that you will continue to press for a solution to this problem.

Sincerely,

ALVIN V. SHOEMAKER.

[From the Daily Bond Buyer, Oct. 6, 1967]

APPROXIMATELY $12.3 MILLION BONDS TO BENEFIT INDUSTRY FOR FLORENCE, KY.

The City of Florence, Ky., is preparing for the sale of approximately $12,300,000 industrial revenue bonds to finance plant facilities for four industries to be located within the city.

Scheduled for sale on Oct. 24 is a $2,100,000 issue of Regeman Electric Co., of Hartford, Conn., manufacturer of electrical control apparatus, wiring devices, and other electrical components.

THREE OTHER ISSUES

Three other issues, anticipated for sale in November, are:

Approximately $5,500,000 for the Hewitt-Robins Co., a division of Litton industries, manufacturer of conveyor systems.

Approximately $2,500,000 for the American Book Co., manufacturer of text books, and a subsidiary of Litton.

$2,200,000 for Globe-Union Inc., of Milwaukee, Wis., manufacturer of electronic devices.

Hayden, Stone, Inc., is financial consultant to the city for these four issues. Grafton, Ferguson, Fleischer & Harper are bond counsel.

BOND BUYER INDEX AT 33-YEAR HIGH

The Bond Buyer's 20 bond, 20-year Index touched a 33-year high yesterday when it registered a 4.25 percent. This represented the tax-exempt market's lowest point since May 1, 1934, when the Index stood at 4.27 percent, and places the market six basis points below last week's figure of 4.19 percent.

In confirmation of the market's lower trend, the higher-grade 11-bond average hit a new recent high of 4.15 percent, up from last week's 4.08 percent, and the highest since Jan. 1, 1934, when it stood at 4.50 percent.

[From the New York Times, Oct. 6, 1967]

BOND RATES SET 33-YEAR RECORD—LEVEL FOR MUNICIPAL ISSUES IS HIGHEST SINCE 1934—SOME SALES DELAYED—INDEX CLIMBS TO 4.25 PERCENT—BIG INDUSTRIAL AID OFFERINGS ARE CITED BY DEALERS AS A REASON FOR SPURT

(By John H. Allan)

Interest rates on tax-exempt municipal bonds have reached their highest level in 33 years, inching above the peak set in late summer last year.

The Bond Buyer's index of municipal bond yields, a widely followed weekly compilation, stood at 4.25 per cent yesterday, up from 4.19 a week ago.

Not since May 1, 1934, has the index been higher. Then, when tax-exemption was not quite the advantage to investors it is today, the index was 4.27.

At the peak of the sequeeze in the credit markets in late August and early September, 1966, the index rose to 4.24 and stayed there, for two weeks.

SOME SALES DELAYED

Since mid-April, municipal bond prices have been falling, and interest rates rising along with other sectors of the money and capital markets.

Recntly, the trend has been accentuated in the municipal bond market by the prospect of a large volume of sales of tax-exempt industrial development bonds. One compilation shows an estimated $825-million of these bonds scheduled for sale throughout the rest of 1967 and early in 1968.

Several cities recently have postponed bond sales because of high interest rates. A Houston sale of $39.8-million of bonds and a $3-million Daytona Beach, Fla., issue were delayed this week, for example.

Investment bankers offering bond issues auctioned in recent weeks have, in several cases permitted the securities to trade in the open market and prices have dropped sharply.

BALANCE OF FAIRFAX ISSUE IS TRADED IN FREE MARKET

The $7.3-million unsold balance of the $55-million Fairfax County, Va., Water Authority was allowed to trade in the free market. Prices dropped enough to raise yields on the bonds 30 basis points or more. When the bonds were originally offered on Sept. 26, they were priced to yield from 4 percent in 1970 to 5 percent in 2007.

The unsold balance of the $35.85-million of Washington bonds offered originally Sept. 13 was freed on Wednesday. Yields also rose about 30 basis points.

As a result, tax-exempted bond dealers seem a bit groggy, but not overwhelmed.

Is the municipal bond market veering toward chaos? Several dealers who were asked agreed conditions were confused, but not chaotic. "I find a lot of weakness but that's a lot different from panic," one investment banker said in a comment that seemed typical.

Another remarked that "things have become pretty bloody." A third commented, "This industrial revenue stuff is killing us."

This was a reference to the buildup in prospective sales of tax-exempt bonds to finance facilities to be leased to private industry. One Wall Street source listed the following 18 issues as likely to come to market over the next six months or so.

Beauregard, Miss., $100-million for the Boise Cascade Corporation; Cheyenne, Wyo., $15-million for Frontier Refining Company (in addition to the $20-million for Wycon Chemical Company) and Corbin, Ky., $7-million.

Also, Copeland, Ala., $100-million; Calcasieu, La., $62.7-million; Florence, Ky., $7-million; Hampden Township, Pa., 7-million to $10-million; Hartwell, Ga., $35-million and Iberville Parish, La., $25-million.

CLINTON, IOWA MAPS NEW BOND OFFERINGS

Also, Lafayette County, Miss., $9.5-million; Mentor, Ohio, $9.8-million: State of Mississippi, $100-million: Astoria, Ore., $142-million; Spartansburg, S.C., $75-million; Warren County, Tenn., $12.5-million; Weatherford, Okla., $8.5-million; Baton Rouge, La., $20-million; and Tama, Iowa, $7.5-million.

In addition, Clinton, Iowa, which negotiated a $60-million industrial aid bond issue last year, is now working to sell $30-million to $60-million more if bondholders approve.

The one bright spot in th tax-exempt bond market recently has been sales of small, highly rated issues. Erie County, N.Y. and Minneapolis, Minn., sold such issues yesterday.

A syndicate managed by the First Boston Corporation won Erie County's $5.25-million. It offered them publicly at yields from 3 percent in 1968 up to 3.80 in 1980—yields little changed from representative triple-A bonds sold a week ago. The bonds were about half sold by late afternoon.

GOVERNMENT AND CORPORATE BONDS REGISTER FEW CHANGES

A Harris Trust and Savings Bank syndicate bought the Minneapolis bonds, scaled them to yield from 3.15 in 1968 to 3.90 in 1987 and have sold all but $615,000.

Prices of Government and corporate bonds showed few changes and traders reported activity as light.

In the new-issue market for corporate securities, Columbia Gas System, Inc., sold $25-million of debentures to a syndicate managed by Merrill Lynch, Pierce, Fenner & Smith, Inc., and White, Weld & Co. The group bid $9.409, specifying a 6⅝ percent rate. It reduced them at 100.304 to yield 6.60 percent to maturity in 1992. The securities are rated single-A and carry no special call protection. The underwriters estimated the issue about 45 percent sold late in the day.

SATURN INDUSTRIES OFFERING IS MADE

The 6.60 percent compares with a return of 6.25 percent on the Wisconsin Natural Gas Company issue marketed Sept. 12 in the preceding sale of single-A gas company securities. The "Whisky Nats," however, were a smaller issue, are a rarer name in the bond market and carry a call price of 113.

A $10-million offering of Saturn Industries, Inc., 5½ percent 20-year convertible debentures priced at 100 was made through Hornblower & Weeks-Hemphill, Noyes and Butcher & Sherrerd and their associates. The group also sold 174,000 common shares at $18.25 a share.

In the Eurobond market, the Kredietbank S. A. Luxembourgeoise reported that loans raised in this market in the first nine months of 1967 totaled $1,241,000,000, a 48 percent rise from the 1966 period. The total for 1967 could approach $2-billion, it predicted, according to Reuters.

In New York, it was reported Kredietbank is readying a unit-of-account loan for Companhia Uniau Fabril, a diversified Portuguese chemical concern. The loan is expected to equal $5-million and be priced at 6¾ at 98. It would mature in 10 years.

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL ON THE GROWING MENACE OF INDUSTRIAL BOND FINANCING, FEBRUARY 23, 1967

Across the country a scheme to saddle the public with the cost of building plants for private use through the misuse of tax-free state and local government bonds has been rapidly gaining momentum. First conceived in Mississippi in the 1930's and confined until recently to the south, this device has been so successful in luring industry to the communities that resort to it, it now has been sanctioned by over 30 states and the list grows year by year. Yet this misuse of public bonds for private-profit purposes threatens the job security of workers everywhere and the welfare of almost everyone.

This plant-enticing scheme is possible through a deliberate perversion of the privilege enjoyed by states and localities to issue bonds on which interest payments are free of all federal tax. These tax-exempt bonds were intended to provide a federal subsidy to help states and localities finance expanded public services. They were not intended, however, to finance the building of plants for private employers—often specifically to lure them from other communities.

The private-profit advantages that result from this abuse of the public bonding privilege are substantial:

Because local government agencies can sell tax-free bonds at a low interest rate, factory-financing costs are considerably lower than when an employer has to raise the money himself.

Moreover, often the employer buys such bonds himself and then pockets the tax-free interest.

What is more, when the employer moves into the plant—often built to his own specifications—he pays only a minimal rental which also is deductible as a business cost, tax-free.

Finally, because the plant is "publicly" owned, even payment of a local property tax generally is evaded.

Each year, this scandalous misuse of tax-free bonds for private profit spreads, and even some of our corporate giants are now getting into the act. And as a consequence, scores of thousands of American workers already have lost their jobs because of the loophole in the federal tax law that encourages plants piracy via industrial bond financing. Ironically, it is the federal taxes paid by all Americans—even those levied on workers who are the victims of this loophole—that subsidize this misuse of public bonds.

What is more, these industrial-bond-financing schemes also cause a mounting federal revenue loss, they undermine business competitors who financed their own plant construction and they saddle local communities with unwholesome burdens of debt. Finally, this perversion of the state and local tax-free bonding privilege undermines the effort of the federal government itself to aid genuinely distressed areas by legitimate means, and to prevent the creation of new ones.

Because of all of these evils, the AFL-CIO has long urged the Congress to end the malpractice of industrial bond financing. And because of the rapid spread of this menace, important allies recently have emerged. Enlightened business groups, the Advisory Commission on Intergovernmental Relations, the Secretary of the Treasury and many Democrats and Republicans in the Congress have expressed deep concern over the dangers inherent in industrial bond financing.

Only a month ago the President's Council of Economic Advisers warned that "the use of the federal tax code in this fashion is inefficient and inappropriate."

While more states are resorting to this undesirable practice, there is a growing desire among the states for the federal government to eliminate it.

The AFL–CIO Executive Council believes the federal government has an obligation to call a halt to this type of industrial piracy because it not only means a loss of needed revenue to the U.S. Treasury and other levels of government but also means an addition to the already unfair tax burden borne by middle and low-income families. The federal tax statutes are already shot full of special privilege and loopholes for industry and the more affluent. To preserve the progressive features of the federal tax laws that remain, and to prevent state and local tax laws from becoming more regressive, the use of tax-exempt bonds for plant piracy must be prohibited.

Once again, the AFL–CIO calls upon the Administration to close the federal tax loophole that has far too long abetted the menace of industrial bond financing. The time for action to end this evil is now.

The bill (S. 2635) to amend the Internal Revenue Code of 1954 to provide that industrial development bonds are not to be considered obligations of States and local governments, the interest on which is exempt from Federal income tax, introduced by Mr. Ribicoff, was received, read twice by its title, referred to the Committee on Finance, and ordered to be printed in the Record, as follows:

S. 2635

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 103 of the Internal Revenue Code of 1954 (relating to interest on certain governmental obligations) is amended by relettering subsection (c) as subsection (a) and by inserting after subsection (b) the following new subsection:

"(c) INDUSTRIAL DEVELOPMENT BONDS.—

"(1) SUBSECTION (a)(1) not to apply. Any industrial development bond (as defined in paragraph (2)) issued after December 31, 1967, shall not be considered an obligation described in subsection (a)(1).

"(2) INDUSTRIAL DEVELOPMENT BOND DEFINED.—

"(A) In general.—For the purposes of this subsection, the term 'industrial development bond' means an obligation the payment of the principal or interest on which is—

"(i) secured in whole or in part by a lien, mortgage, pledge, or other security, interest in property of a character subject to the allowance for depreciation, or

"(ii) secured in whole or in part by an interest in (or to be derived primarily from) payments to be made in respect of money or property of a character subject to the allowance for depreciation, which is or will be used, under a lease, sale or loan arrangement, for industrial or commercial purposes.

"(B) Exceptions.—For purposes of subparagraph (A), property shall not be treated as used for industrial or commercial purposes if it is used—

"(i) to provide entertainment (including sporting events) or recreational facilities for the general public;

"(ii) to provide facilities for the holding of a convention, trade show, or similar event;

"(iii) as an airport, dock, wharf, or similar transportation facility;

"(iv) in the furnishing or sale of electric energy, gas, water, or sewage disposal services; or

"(v) in an active trade or business owned and operated by any organization described in subsection (a)(1).

"(3) EXCEPTIONS.—Paragraph (1) shall not apply to any obligation issued before January 1, 1969, for a project assisted by the United States under title I of the Houseing Act of 1949 (42 U.S.C., sec. 1450 and following, relating to slum clearance and urban renewal) or under title I or title II of the Public Works and Economic Development Act of 1965 (42 U.S.C., sec. 3131 and following)."

(b) Section 102(g) of the Housing Act of 1949, as amended (42 U.S.C., sec. 1452 (g)), is amended to read as follows:

"(g) Obligations, including interest thereon, other than industrial development bonds (within the meaning of section 103(c) of the Internal Revenue Code of

1954), issued by local public agencies for projects assisted pursuant to this title, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

(c) The amendment made by subsection (a) shall apply with respect to taxable years ending after December 31, 1967.

The technical explanation of Senate bill 2635, presented by Mr. Ribicoff, is as follows:

TECHNICAL EXPLANATION OF PROPOSED AMENDMENT TO SECTION 103 OF THE INTERNAL REVENUE CODE OF 1954 RELATING TO INDUSTRIAL DEVELOPMENT BONDS

The proposed bill amends section 103 of the Internal Revenue Code by adding new subsection (c). Paragraph (1) of subsection (c) provides simply that an industrial development bond issued after December 31, 1967, shall not be considered an obligation of a State or local government the interest on which is exempt from tax. The definitional aspects of the proposed bill contains the major substantive provisions.

Paragraph (2) of new subsection (c) defines the term "industrial development bond" as any obligation the payment of principal and interest on which is either—(1) secured by an interest in property of a character subject to the allowance for depreciation or (2) secured (or to be derived primarily from) payments to be made with respect to money or property of a character subject to the allowance for depreciation—which is or will be used, under a lease, sale or loan arrangement for industrial or commercial purposes. In the case of the typical industrial development bond the issuing governmental unit uses the proceeds to construct a facility for lease to a private corporation and an interest in the property is pledged as security for the rental payments. In other cases a deferred payment sale contract may be used instead of a lease but the substance of the transaction is not otherwise altered. In still other cases the bond proceeds may be loaned directly to the private corporation as a working capital loan, to purchase equipment, or for similar purposes. However, irrespective of whether the transaction takes the form of a loan, sale, or lease, it is normal to secure payment of the bonds by pledging either the specific property involved or the payments to be made under the loan, lease or sale contract. Therefore, subparagraph (A)(i) and (ii) includes within the definition of industrial development bond all obligations the payment of principal or interest on which is secured by either (i) the specific property or (ii) an interest in the payments to be made with respect to money loaned or non-depreciable property leased or sold for industrial or commercial purposes.

The essence of an industrial development bond is that it is a device for passing on the benefits of the interest exemption to a private industrial or commercial enterprise. By limiting the definition to cases in which such an enterprise uses the property under a lease, sale or loan arrangement and by also requiring that the property or payment with respect to such property be pledged as secuity for the obligation, the bill carefully delineates these financial transactions which involve bonds issued for the purpose of financial industrial or commercial enterprises. Further, by limiting the property involved to cash loans and depreciable property the bill excepts transactions, such as many industrial parks, which involve unimproved land exclusively. The bill thus recognizes that there may be situations where, if land is to be used, a governmental unit must make initial preparations (such as filling a swamp or installing sewage facilities) that no private entrepreneur would be willing or capable of undertaking. However, if in addition to land depreciable property, such as a factory or department store is involved, and the issue is secured in part by such depreciable property the bonds will constitute industrial development bonds.

In addition, if a local government creates a separate governmental authority to issue industrial development bonds, or if a nonprofit corporation is used with authority to issue bonds on behalf of a local government, it is possible to achieve the effect of a security interest in property without a direct pledge of the property involved. This would be true, for example, where an industrial financing authority was created and its powers limited so that its income was primarily derived from the lease or sale of industrial facilities and its expenditures limited in such a way that most of its income could only be expended on principal and interest payment for issued bonds. Since this situation would be tantamount to a security arrangement, the parenthetical clause of part (ii) of subparagraph (A) includes bonds issued in circumsances which demonstrate that repayment is primarily to be derived from payments on a lease, sale, or loan to a private corporation. The provision does not, of course, extend to obligations of a local government merely because, in addition to performance of its normal governmental functions, the government also owns property which it happens to lease for industrial or commercial purposes.

The phrase "industrial or commercial purposes" is intended to have its customary meaning and is not specifically defined by the bill. Thus, for example, bonds issued to construct a facility for an exempt organization, such as a college dormitory, would not be an industrial development bond. In addition, subparagraph (B) of paragraph (2) provides that leases for certain specified purposes shall not be considered leases for industrial or commercial purposes within the purview of the bill. Specifically enumerated are bonds issued to finance facilities which are leased for the purposes of providing entertainment or recreation; for holding of a convention, trade show or similar event; as an airport, dock, wharf or similar transportation terminal; or in the furnishing or sale of electric energy, gas, water, or sewage disposal services. Thus, for example, bonds issued to finance a stadium run by the municipality and leased to various profit-making enterprises for baseball, football and other similar events, would not be industrial development bonds.

Subparagraph (B)(v) adds a more general exception to make it clear that bonds issued with respect to property used in active trade or business owned and operated by a governmental unit will not be industrial development bonds. Thus, for example, if a municipality were to issue bonds to finance a large apartment building which was to be leased to a substantial number of different tenants with the length of the leases unrelated to the life of the bonds, the municipality would be engaged in the active conduct of a real estate rental business and the bonds in question would not be industrial development bonds within the meaning of this provision. The present bill is confined to cases where the arrangement involves an attempt by a State or local government to pass on to private commercial enterprises the lower interest rates which result from the exemption of interest on State and local bonds.

In accordance with paragraph (1) or new subsection (c) the bill as applicable to bonds issued after December 31, 1967, and applies with respect to taxable years ending after that date. However, since certain Federally assisted projects may involve the issuance of industrial development bonds, paragraph (3) of new subsection (c) provides as a limited transition rule for such cases that only bonds issued after January 1, 1969, will be considered industrial development bonds. Section (g) of the draft bill makes a conforming change in the Housing Act of 1949.

The bill (S. 2636) to amend the Internal Revenue Code of 1954 to provide that arbitrage bonds are not to be considered obligations of States and local governments the interest on which is exempt from Federal income tax, introduced by Mr. Ribicoff, was received, read twice by its title, referred to the Committee on Finance, and ordered to be printed in the Record, as follows:

S. 2636

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assmbled, That (a) section 103 of the Internal Revenue Code of 1954 (relating to interest on certain governmental obligations) is amended by relettering subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ARBITRAGE BONDS.—

"(1) SUBSECTION (a)(1) NOT TO APPLY.—Any arbitrage bond (as defined in paragraph (2)) shall not be considered an obligation described in subsection (a)(1).

"(2) ARBITRAGE BONDS DEFINED.—

"(A) In general.—For purposes of this subsection, the term 'arbitrage bond' means any obligation if, under the terms of the obligation or any underlying agreement, any portion of the proceeds of the issue of which the obligation is a part may be invested, directly or indirectly, in any securities (other than obligations the interest on which is excluded from gross income under subsection (a) after the application of this subsection) which yield a higher return (taking into account any discount or any premium) that the obligation being issued, and such securities are required to be held as security for any obligation the interest on which is excluded from gross income under subsection (a) before the application of this subsection.

"(B) Exceptions.—Subparagraph (A) shall not apply to an obligation—

"(1) if under the terms of the obligation or underlying agreement all of such securities (other than those described in (ii) and (iii) below) in which the proceeds may be invested may not be held longer than two years from the date of the issuance of the obligation;

"(i) if under the terms of the obligation or underlying agreement all of such

"(ii) if the obligation or any underlying agreement limits the amount of the proceeds which may be invested in such securities as of the beginning of any annual accounting period provided for in the obligation or underlying agreement to not more than the amount of interest and principal payments required to be made with respect to such obligation within such annual accounting period and the accounting period following such annual accounting period.

"(iii) to the extent that the proceeds of such obligation are to be used to construct a facility the actual construction of which (other than acquisition of land) must commence within two years from the date of such issuance if under the terms of the obligation or underlying agreement the portion of the proceeds to be used in connection with such construction may not be invested in such securities for a period in excess of five years from the issuance of such obligation.

"(3) SPECIAL SERIES OF OBLIGATIONS.—At the request of an organization described in subsection (a)(1), the Secretary is authorized under the Second Liberty Bond Act, as amended (31 U.S.C., sec. 752 and following), to provide for the issuance of a special series of obligations of the United States the yields on which shall not exceed the yields on obligations described in paragraph (2).

(b) The amendment made by subsection (a) shall apply only with respect to interest on bonds issued after the date of the enactment of this Act.

The technical explanation of Senate bill 2636, presented by Mr. RIBICOFF, is as follows:

TECHNICAL EXPLANATION OF PROPOSED AMENDMENT TO SECTION 103 OF THE INTERNAL REVENUE CODE OF 1954 RELATING TO ARBITRAGE BONDS

The proposed bill amends section 103 of the Internal Revenue Code by adding new subsection (c). Paragraph (1) of Subsection (c) provides that an arbitrage bond shall not be considered an obligation of a State or local government the interest on which is exempt from tax.

Paragraph (1) of new subsection (c) defines the term "arbitrage bond." Subparagraph (A) provides that a bond will only be considered an arbitrage bond (1) of under the terms of the issue, the State or local government may invest the proceeds of the issue in taxable obligations yielding a higher rate of interest than the issue in question, and (2) if the portion of the proceeds so invested is required to be held as security for the payment of the issue in question or any other bond issue the interest payments on which are exempt from Federal income tax.

This definition and the several exceptions discussed below have been drafted in a manner that will permit a prospective purchaser to determine from the terms of the obligation and underlying agreement that a given obligation is not an arbitrage bond. By the same token an issuing governmental unit, by carefully drafting the bond agreement, can insure that a bond will not come within the definition of an arbitrage bond. This aspect of the bill as well as the exceptions contained in subparagraph (B) will allow State and local governments unfettered freedom to engage in any financing arrangement necessary to achieve the basic purpose of a particular bond issue. Subparagraph (B) excludes from the definition of an arbitrage bond certain common situations which may require a limited investment of the proceeds in taxable securities and it is anticipated that these exceptions will render the bill inapplicable to the vast majority of governmental bond issues. It is also recognized however, that certain abnormal situations may prompt the issuance of bonds which require an investment exceeding the specified limitations. A municipality, confronted with such an abnormal situation, may avoid the provisions of the bill if it confines any investment exceeding the specified limits to securities which do not yield a higher rate of interest than the bonds being issued. Paragraph (3) of the new subsection (c) authorizes the Secretary of the Treasury to provide for the issuance of special federal obligations which will meet this requirement for municipalities which are unable to purchase bonds yielding the same or a lower interest rate as the issue in question on the open market.

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For example, municipalities often find it desirable to engage in advance refunding transactions in order to insure an orderly transition between an outstanding issue approaching maturity and a new issue which is to replace the maturing bonds. The municipality will invest the proceeds of the new issue in securities to be held in escrow for the benefit of the outstanding bonds. Subparagraph (B) (i) of the new subsection (c) (3) provides a general two year exception which would exclude advance refunding issues from the definition of an arbitrage bond if the proceeds could not be invested in higher yield taxable securities for longer than two years. The two year limitation contains the investment profit within tolerable limits and insures that any profit that result is primarily a by-product of the transaction rather than its essential purpose.

On the other hand, in certain unusual cases it may be desirable to invest the proceeds of an advance refunding issue for a period exceeding two years. An oft cited example involves revenue bonds which were issued to build a bridge and which contain a restrictive covenant prohibiting the erection of a second bridge in the same area. A municipality may engage in an advance refunding transaction in order to secure a release from the restrictive covenant and simultaneously raise revenues to build a second bridge. If the portion of the proceeds which are to be held in escrow for the outstanding bonds are to be held for a period in excess of two years (because the outstanding bonds are not callable) the newly issued bonds will constitute arbitrage bonds under the bill unless the municipality also agrees that the proceeds will not be invested in bonds yielding a higher rate of interest than the advance refunding bonds once the two year period is past. If it is necessary, to comply with such an agreement, the municipality may request the Secretary of the Treasury to issue a special series of federal bonds whose yields will not exceed the interest on the advance refunding issue. In this way the bill provides maximum flexibility for all state and local government financing needs while limiting the amount of unjustified profit that may be realized through arbitrage trading on the interest differential between taxable and nontaxable obligations.

In addition to a general two year exception, subparagraph (B) (ii) permits a State or local government to set aside out of the proceeds of a new issue and invest an amount equal to that needed to pay the interest and principal (if any) during a two year period after the date of issue of the obligation. The fund so set aside and invested as a debt service reserve must be reduced in future years as bonds are paid off and the interest and principal requirements needed to meet payments during successive two year periods becomes smaller. Part (iii) of subparagraph (B) provides an additional exception for bonds issued to construct new facilities. Under that provision, if construction is to commence within one year of the bond issue, the proceeds borrowed to permit construction may be invested in taxable obligations yielding a higher return for up to five years from the date of the bond issue.

As in the case of the advance refunding bonds, if a municipality finds it necessary to have a larger debt service reserve or to have a longer construction reserve, the bonds will not constitute arbitrage bonds if the municipality confines the investment which exceeds the specified amount or period to securities which do not yield a higher rate of interest than the interest called for by the bonds in question.

HOUSE, SENATE, AND CONFERENCE REPORTS ON § 601(a) OF H.R. 13270, THE TAX REFORM ACT OF 1969, RELATING TO ARBITRAGE BONDS

H. Rept. 91–413 (Part 1) pp. 172–174

Y. TAX TREATMENT OF STATE AND MUNICIPAL BONDS

(Secs. 601 and 602 of the bill and sec. 103 of the code)

Present law.—Present law provides that interest on obligations of State and local governments generally is exempt from Federal income tax, an exemption that has been provided ever since the Fedral income tax was adopted in 1913.

Interest payments on obligations issued by the United States after September 1, 1917, are subject to Federal tax, in contrast with interest on State and local government obligations.

State and local governments generally do not directly tax interest on Federal bonds, but they tax the interest income on bonds issued by other States. Some

States impose their income tax as a percentage of the Federal income tax liability, and in these cases the States, in effect, are taxing income on Federal bonds.

The Revenue and Expenditure Control Act of 1968 withdrew tax-exempt status from industrial revenue bonds which States and local governments were using to finance and attract private industrial development within their jurisdictions. This legislation applies generally to industrial levelopment bonds issued after April 30, 1968, and was intended to prevent States and local governments from abusing the tax-exempt status of their obligations by using it as a basis for interstate competition to attract industry. The legislation, however, was not intended as an attack or limitation on the general principle of tax exemption for State and local government obligations.

There are presently no other specific restrictions in the code upon these tax-exempt obligations, nor upon the use of the proceeds from their issue.

Although the present legal basis for the exemption of interest on State and local obligations from the Federal income tax is found only in section 103(a) of the code, there is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local obligations without the consent of the issuing governments. It also is maintained that the exemption is part of a federal system of government under which the Federal Government does not infringe on the powers of the State and local governments. This position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities.

General reasons for change.—Capital outlays of State and local governments for such projects as schools and other public buildings, highways, water and sewage systems, and antipollution facilities have doubled during the past decade. In order to market an increasing volume of securities to finance these public projects in competition with a growing volume of private borrowings, State and local governments have been offering higher yields, and the differential between tax-exempt and taxable securities of comparable quality has been narrowing. Historically, the ratio of yields on tax-exempt issues to taxable issues has been as low as 60 percent, but in recent years it has been close to 75 percent.

The ratio of yields has varied in response to the general availability of credit, the demand for credit and the proportionate demand by State and local governments to the total market demand for credit. As a result, high income individuals and institutions otherwise subject to high tax rates who constitute a major portion of the market for tax-exempt State and local securities have been receiving significantly larger tax benefits than needed to bring them into the market. Recent estimates place the annual saving in interest charges to State and local governments at $1.3 billion, but the annual revenue loss to the Federal Government has been estimated at $1.8 billion.

Several procedures have been recommended in the past several years which would make taxable the debt instruments that finance State and local government capital outlays, but which also would maintain the reduced interest cost to these governments through some form of subsidy. Generally, recommendations have been unattractive to State and local governments because some authority would review the need for the project that gives rise to the debt issue and the ability of the issuer to meet the obligation, and because the proposals provided for annual appropriations from Congress to make up the difference between taxable and nontaxable yields.

Some State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from tax-exempt issues are employed to purchase higher yielding Federal obligations whose interest is not taxed in their hands. The tax-exempt issue in these cases generally specifies that the interest on the Federal bonds will be used to service the State and local securities. An individual who purchases a State or local security under such an arbitrage arrangement has the advantage of a tax-exempt security with the safety of a Federal security. The Federal Government then finds itself in the position of becoming an unintended source of revenue for State and local governments while losing the opportunity to tax the interest income from its own taxable bond issues. The Internal Revenue Service has announced that it will not rule on the question whether such arbitrage obligations are entitled to tax exemption under existing law.

Explanation of provision

1. Election to issue taxable bonds and interest subsidy.—In order to encourage States and their political subdivisions voluntarily to relinquish the privilege of tax exemption for their debt securities, your committee's bill provides that the Secretary of the Treasury is to pay a fixed percentage of the interest yield on each issue of obligations for which the issuer elects taxable status. Before the first day of each calendar quarter, the Secretary or his delegate, is to determine and publish in the Federal Register the fixed percentage of interest yield which he determines is necessary for this purpose. The fixed percentage is to apply to all issues of taxable obligations made during such calendar quarter.

These provisions of the bill are entirely elective; if the issuer elects that the issue shall not be tax exempt, the fixed percentage subsidy follows automatically. There is no review of the advisability of the local project or of the issuer's ability to repay.

Under the bill, the fixed percentage to be paid by the United States may vary within a range that is not less than 25 percent and not more than 40 percent of the interest yield for calendar quarters beginning after December 31, 1974. Between the date of enactment and January 1, 1975, the fixed percentage may not go below 30 percent of the interest yield. The use of a range, instead of a constant fixed percentage, will permit the Secretary to take into account fluctuations in the ratio of tax-exempt yields to taxable yields that reflect the general supply of credit in the money market and the demand for credit. Determination of the interest yield on any issue of obligations is to be made immediately after they have been issued.

A State or local government issuing a debt obligation subject to the provisions provided by the bill may choose to have the fixed percentage the United States is to pay represented by a separate set of coupons attached to the bond which shall be obligations of the United States to the holder. It is thought that the use of such dual coupon obligations might be necessary to avoid violation of the maximum interest limitations imposed on some States and localities by local law.

Payment of the interest subsidy by the United States will be made to the issuer, even in the case of dual coupon obligations, unless the issuer requests that payment be made to a specified paying agent. In no case will the United States be required to assume the administrative burden of making payment directly to the holders of the obligations.

The United States is required to pay its portion of the interest on taxable obligations not later than the time the issuer is required to pay interest on the obligations. Where it is the most practicable method of effecting the intent of the bill, adjustment for any premium or any discount at which the obligations are issued may be made between the issuer and the United States at the time of issuance or such later time or times as may be appropriate.

2. Arbitrage obligations.—For the reasons discussed above, your committee's bill repeals the privilege of exemption from Federal income taxation with respect to arbitrage obligations. It is contemplated that the regulations to be issued by the Secretary of the Treasury concerning this section of the bill will provide rules for the temporary investment of proceeds from a State or local government obligation pending their expenditure for the governmental purpose which gave rise to the issue.

Effective date.—This provision, as it related to the election to issue taxable securities and the interest subsidy, is to apply to obligations issued in calendar quarters beginning after the date of enactment of the bill. As it relates to the repeal of the tax exemption on arbitrage bonds, this provision is to apply to obligations issued after July 11, 1969.

Revenue effect.—It is estimated that there will be no revenue loss with respect to governments which elect to issue taxable bonds and receive the interest subsidy, as the revenue gained by taxation of the interest on such obligations will more than offset the cost of the subsidy.

(Senate Rept. 91-552, pp. 219-220)

SECTION 601. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS

(a) In general.—Subsection (a) of section 601 of the bill amends section 103 of the code (relating to interest on certain governmental obligations) by redesignating subsections (b) and (d) as subsections (e) and (f), respectively, and by inserting a new subsection (b).

Election to issue taxable bonds

Paragraph (1) of new section 103(b) provides that the issuer of obligations described in section 103(a)(1) may elect to issue obligations to which such section 103(a)(1) will not apply. Thus, if an issuer of such obligations so elects with respect to an issue of obligations, the interest on such obligations will not be excluded from gross income under section 103(a). New subsection (b) of section 103 applies only to obligations described in existing section 103(a)(1) (obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia). Thus it does not apply to (1) any industrial development bond which under existing section 103(a) is treated as an obligation not described in section 103(a)(1), and (2) any arbitrage obligation which under new subsection (d) of section 103 (discussed below) is treated as an obligation not described in section 103(a)(1).

Election

Paragraph (2) of new section 103(b) provides that an election to issue obligations to which section 103(a)(1) will not apply is to be made at such time, in such manner, and subject to such conditions as may be provided by regulations prescribed by the Secretary of the Treasury or his delegate. A separate election is to be made for each issue of obligations to which section 103(a)(1) is not to apply. An election with respect to any issue once made is irrevocable.

(*b*) *Arbitrage obligations.*—Subsection (b) of section 601 of the bill amends section 103 of the code by inserting a new subsection (d).

New subsection (d) of section 103 provides that, under regulations prescribed by the Secretary of the Treasury or his delegate, an arbitrage obligation is to be treated as an obligation which is not described in section 103(a)(1). In the case of any arbitrage obligation which, pursuant to regulations, is treated as an obligation not described in section 103(a)(1), the interest on such obligation will not be excluded from gross income under section 103 and the election provided in new subsection (b) of section 103 (discussed above) will be available for such obligation.

(*c*) *Clerical amendment.*—Subsection (c) of section 601 of the bill revises the heading of subsection (e) of section 103, as redesignated by subsection (a) of such section 601.

(*d*) *Effective dates.*—Subsection (d) of section 601 of the bill provides that the amendments made by subsection (a) of section 601 of the bill are to apply to obligations issued in calendar quarters beginning after the date of the enactment of section 601, and that the amendment made by subsection (b) is to apply to obligations issued after July 11, 1969.

SECTION 602. UNITED STATES TO PAY FIXED PERCENTAGE OF INTEREST YIELD ON TAXABLE ISSUES

Section 602 of the bill provides for the payment by the Secretary of the Treasury or his delegate of a portion of the interest yield on each issue of obligations described in section 103(a)(1) of the Internal Revenue Code of 1954 to which an election under section 103(b) of such code(added by section 601(a) of the bill) applies.

Permanent appropriation

Subsection (a) of section 602 of the bill appropriates, out of any moneys in the Treasury not otherwise appropriated, such sums as may be necessary to carry out the provisions of section 602, and provides that such appropriations are to be deemed permanent annual appropriations.

Payment of fixed percentage of interest yield

Subsection (b) of section 602 relates to the computation and payment by the Secretary of the Treasury or his delegate of a fixed percentage of the interest yield on obligations to which an election under section 103(b) applies.

Paragraph (1) of section 602(b) directs the Secretary of the Treasury or his delegate to pay a fixed percentage of the interest yield on each issue of obligations to which an election under section 103(b) applies. Such paragraph (1) provides that the Secretary or his delegate shall, before the first day of each calendar quarter, determine, and publish in the Federal Register, the fixed percentage of interest yield which he determines it is necessary for the United States to pay in order to encourage the governmental units referred to in section 103(a)(1) (a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia) to make elections under section 103(b). The fixed percentage so determined is to be—

(1) not less than 30 percent and not more than 40 percent for calendar quarters beginning before January 1 1975, and

(2) not less than 25 percent and not more than 40 percent for calendar quarters beginning after December 31, 1974.

The fixed percentage determined, and published in the Federal Register, in a calendar quarter, is to apply with respect to each issue of obligations to which an election under section 103(b) applies, made during the immediately succeeding calendar quarter.

Paragraph (2) of section 602(b) provides that the interest yield on any issue of obligations (to which an election under section 103(b) applies) is to be determined immediately after the issuance of such obligations.

* * * * * * *

2. ARBITRAGE BONDS

Present law.—Arbitrage bonds generally are obligations issued to acquire other securities where the rate of return of the other securities produces a higher yield than the interest cost on the initial bond issue. Present law does not specifically preclude the issuance of bonds for such purposes by State or local governments. However, questions have been raised in such cases as to whether such bonds in reality are obligations of a State or local government where the proceeds from the securities acquired secure the payments under the initial bonds. As a result, in recent years the Internal Revenue Service has refused to rule as to whether or not bonds issued in such circumstances constitute tax-exempt State or local government bonds.

General reasons for change.—Some State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from the tax-exempt issues are employed to purchase higher yielding Federal or other obligations the interest on which is not taxed in their hands. The tax-exempt issue in these cases generally specifies that the interest on the Federal bonds or other obligations will be used to service the State and local securities. An individual who purchases a State or local security under such an arbitrage arrangement has the advantage of a tax-exempt security with the safety of a Federal security. The Federal Government then finds itself in the position of becoming an unintended source of revenue for State and local governments while losing the opportunity to tax the interest income from its own taxable bond issues. The Internal Revenue Service has announced that it will not rule on the question whether such arbitrage obligations are entitled to tax exemption under existing law.

Explanation of provision.—Both the House bill and the committee amendments make provision for the taxation of arbitrage bonds issued by State or local governments. The House bill provided that, under regulations prescribed by the Secretary of the Treasury or his delegate, any arbitrage obligation was not to be treated as a tax-exempt State or local government bond. It was contemplated that the regulations issued by the Secretary of the Treasury would provide rules for the temporary investment of proceeds from the State or local government obligation pending their expenditure for the governmental purpose which gave rise to the issue.

The committee amendments also provide that arbitrage bonds are not to be treated as tax-exempt State or local government issues. However, under the committee amendments, arbitrage bonds are defined. They are in general defined as obligations issued where all or a major part of the proceeds can be reasonably expected to be used (directly or indirectly) to acquire securities or obligations which may be reasonably expected, at the time of the issuance of the State or local obligation, to produce a yield which is materially higher than the yield on the State or local governmental bond issue. Arbitrage bonds are also defined as including obligations issued to replace funds which were used to acquire (directly or indirectly) the type of securities or obligations referred to above.

The definition of arbitrage bonds for purposes of this provision is not to include where substantially all of the proceeds of the issue are reasonably expected to be used to provide permanent financing for real property used, or to be used, for residential purposes (or to replace funds so used) where the yield on the State or local government obligations at the time of issue is not expected to be substantially lower than the yield on the permanent financing. (This exception does not apply to State or local government obligations held by a person who is a substantial user of property financed by the proceeds of the issue or by a member of his family.)

In addition, an obligation is not to be treated as an arbitrage bond solely because the proceeds of the issue may be invested in securities or other obligations for a temporary period until the proceeds are needed for the purpose for which the State or local government bonds were issued. Nor are obligations to be classified as arbitrage bonds where the proceeds of the State or local government issue may be invested in securities or other obligations which are part of a reasonably required reserve or replacement fund. The amount of the proceeds invested in securities or obligations which are part of a required reserve or replacement fund may not exceed 15 percent of the total proceeds of the issue unless the issuer establishes that a higher amount is necessary.

Effective date.—The committee amendments are effective with respect to obligations issued after October 9, 1969. The House provision would have applied to obligations issued after July 11, 1969.

Revenue effect.—The revenue effect from taxation of the interest income from arbitrage bonds is expected to be negligible, since the provision probably will eliminate such issues in the future.

(Conference Report 91-782, pp. 323-324)

TITLE VI—STATE AND LOCAL OBLIGATIONS

1. Arbitrage bonds (sec. 103(d) of the code)

The House bill provides for the taxation of arbitrage bonds issued by State or local governments. The bill provides that, under regulations issued by the Secretary or his delegate, any arbitrage obligation is not to be treated as a tax-exempt State or local government bond.

The Senate amendment makes four modifications in the House bill:

(1) The amendment defines arbitrage bonds as obligations issued where all or a major part of the proceeds can be reasonably expected to be used (directly or indirectly) to acquire securities or obligations which may be reasonably expected, at the time of the issuance of the State and local obligation, to produce a yield which is materially higher than the yield on the State or local governmental bond issue.

(2) Arbitrage bonds are defined as not including issues where a major part of all of the proceeds of the issue are reasonably expected to be used to provide permanent financing for real property used, or to be used, for residential purposes where the yield on the Government obligation at the time of issue is not expected to be substantially lower than the yield on the permanent financing.

(3) An obligation is not treated as an arbitrage bond solely because the proceeds of the issue may for a temporary period be invested in higher yield securities or other obligations until the proceeds are used for the purpose for which the State or local government bonds were issued. Nor are obligations to be classified as arbitrage bonds where the proceeds of the Government issue may be invested in higher yield securities which are part of a reasonable reserve or replacement fund so long as this fund does not exceed 15 percent of the total issue (unless the issuer establishes that a higher amount is necessary).

(4) This provision of the amendment is effective with respect to obligations issued after October 9, 1969 (after July 11, 1969) under the House bill).

The conference substitute (sec. 601 of the substitute and sec. 103(d) of the code), follows the Senate amendment except that in the case of the modification described in No. (2) above the permanent financing for real property is limited to real property used, or to be used, for residential purposes for the personnel of an educational institution of higher learning.

2. House provision omitted from conference substitute—election to issue taxable bonds and information reporting (secs. 6056 and 6685 of the code under the Senate amendment)

The House bill provides that States and local governments can voluntarily relinquish the tax exemption with respect to given debt security issues and in these cases the Secretary or his delegate is to pay a fixed percentage of the interest yield on each such issue. The fixed percentage may vary within a range of 30 to 40 percent of the yield up to 1975 and from 25 to 40 percent of the yield thereafter.

The Senate amendment deletes this provision of the House bill. It substitutes a requirement that every person who receives or accrues $600 or more of tax-exempt State and local government bond interest or who is required to file an income tax return is to report the amounts of any tax-exempt State or local government bond interest he receives.

The conference substitute omits both the provision of the House bill and the provision of the Senate amendment.

STATEMENT OF TREASURY POSITION ON § 601(a) OF H.R. 13270, THE TAX REFORM ACT OF 1969, RELATING TO ARBITRAGE BONDS (HEARINGS: SFC, PART 1)

1. Subsidy for taxable issues

Treasury recommends that the provisions in the House bill providing an election to state and local governmental units to issue taxable bonds and for payment by the Federal Government of a percentage of the interest yield on such taxable issues be deleted. The Administration is developing an alternative provision which will be submitted to the Congress in due course.

2. Arbitrage obligations

Some states and localities have used funds received from the issuance by them of tax-exempt bonds to purchase higher yield taxable securities. Since municipal governments are not subject to Federal income taxes, the interest received is not taxed in their hands; the issuer thus profits in an amount equal to the spread between the tax-exempt interest paid and the higher interest received on the higher yield taxable securities. The House bill deals with this problem by providing that an "arbitrage obligation" shall not be entitled to tax-exempt status. The definition of an arbitrage obligation is left to regulations.

Treasury supports the objective of the bill to deny tax-exempt status to state and local bonds issued in a true arbitrage transaction. However, Treasury recommends that the bill be amended to provide a rule which may be easily understood and applied and which furnishes a clearer standard to be followed in the regulations. Treasury proposes that an obligation be considered an "arbitrage obligation" if, under regulations prescribed by the Secretary or his delegate the circumstances (including but not limited to the terms of the obligation, the specified purpose of the issue, the nature of the security provided for the obligation, and all other relevant facts) demonstrate that the result of the issuance is the realization of an arbitrage profit from reinvestment of the proceeds in higher yield securities other than governmental obligations to which section 103(a) of the Code applies.

The provision, however, should contain explicit authority for the regulations to treat temporary investment of the proceeds of an issue in higher yield securities as not constituting an arbitrage transaction where substantially all of the proceeds of the issue are used within a specified period for other purposes, such as construction of new government facilities. Similarly, authority should be given to provide that obligations issued to refund obligations then outstanding which are not themselves arbitrage obligations will not be arbitrage obligations if the refunding is completed within a stated period.

Further, explicit authority should be given to exclude from the definition of an arbitrage obligation any obligation the proceeds of which are used to provide permanent financing (mortgage funds) for family housing, sports facilities, or other exempt activities specified in section 103(c) of the Code. No limit is placed in the Code on the issuance of tax-exempt bonds to construct governmental facilities which may in fact produce a profit from operation. The same considerations justifying the blanket exemptions from industrial revenue bond treatment apply with respect to funds used to provide mortgage financing for the construction of such facilities. The exception should only be available if the yield received on such mortgage obligations does not substantially exceed the interest yield on the obligations of the state or local government. Further, a limitation should be included making the exception inapplicable with respect to such obligations of the state or local government for any period for which they are held by the mortgagor (see, for example, section 103(c)(7) of the Code).

§ 103(d) of 1954 Internal Revenue Code as Amended

§ 103. Interest on certain governmental obligations.

* * * * * * *

(d) Arbitrage bonds.

(1) Subsection (a)(1) not to apply.

Except as provided in this subsection, any arbitrage bond shall be treated as an obligation not described in subsection (a)(1).

(2) Arbitrage bond.

For purposes of this subsection, the term "arbitrage bond" means any obligation which is issued as part of an issue all or a major portion of the proceeds of which are reasonably expected to be used directly or indirectly—

(A) to acquire securities (within the meaning of section 165(g)(2)(A) or (B)) or obligations (other than obligations described in subsection (a)(1)) which may be reasonably expected at the time of issuance of such issue, to produce a yield over the term of the issue which is materially higher (taking into account any discount or premium) than the yield on obligations of such issue, or

(B) To replace funds which were used directly or indirectly to acquire securities or obligations described in subparagraph (A).

(3) Exceptions.

Paragraph (1) shall not apply to any obligation—

(A) which is issued as part of an issue substantially all of the proceeds of which are reasonably expected to be used to provide permanent financing for real property used or to be used for residential purposes for the personnel of an educational institution (within the meaning of section 151(e)(4)) which grants baccalaureate or higher degrees, or to replace funds which were so used, and

(B) the yield on which over the term of the issue is not reasonably expected, at the time of issuance of such issue, to be substantially lower than the yield on obligations acquired or to be acquired in providing such financing.

This paragraph shall not apply with respect to any obligation for any period during which it is held by a person who is a substantial user of property financed by the proceeds of the issue of which such obligation is a part, or by a member of the family (within the meaning of section 318(a)(1)) of any such person.

(4) Special rules.

For purposes of paragraph (1), an obligation shall not be treated as an arbitrage bond solely by reason of the fact that—

(A) the proceeds of the issue of which such obligation is a part may be invested for a temporary period in securities or other obligations until such proceeds are needed for the purpose for which such issue was issued, or

(B) an amount of the proceeds of the issue of which such obligation is a part may be invested in securities or other obligations which are part of a reasonably required reserve or replacement fund.

The amount referred to in subparagraph (B) shall not exceed 15 percent of the proceeds of the issue of which such obligation is a part unless the issuer establishes that a higher amount is necessary.

(5) Regulations.

The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this subsection.

Senator Bentsen. Our next witness is Mr. Walter R. Chambers, chairman of the Public Securities Association.

Mr. Chambers, we are pleased to have you.

Would you please introduce your associate.

STATEMENT OF WALTER R. CHAMBERS, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, WASHINGTON, D.C., ACCOMPANIED BY BY ARTHUR J. KALITA, ASSISTANT DIRECTOR FOR REGULATION, PUBLIC SECURITIES ASSOCIATION

Mr. Chambers. Thank you, Mr. Chairman.

This is Mr. Arthur Kalita, our assistant director for regulation and legislation of our association.

Senator BENTSEN. Would you please pull the microphone closer to you or speak louder so that everyone in the audience can hear your comments, also.

Mr. CHAMBERS. Certainly.

Mr. Chairman and members of this distinguished committee, Public Securities Association is pleased to have this opportunity to present its views concerning the Treasury department's proposed amendments to the arbitrage bond regulations that were published on May 8, 1978. PSA is a national trade association representing some 260 dealers and dealer banks which provide underwriting and financial advisory services for State and local government.

In 1977, PSA members participated in approximately 80 percent of the underwritings of new municipal securities that came to the market.

PSA offers its comments concerning the proposed arbitrage bond regulations from the perspective of its members as participants in the tax exempt market.

We have submitted detailed comments on the proposed regulations to the Treasury and the Internal Revenue Service and have urged withdrawal of the May 8 proposals in our letters and in our testimony at a public hearing on July 25, 1978.

Copies of the PSA's letters on the subject are attached to this statement and we request that they be included in the record for this hearing.

Senator BENTSEN. They will be.

Mr. CHAMBERS. We hope that our comments will assist this committee as it considers what steps should be taken to insure the arbitrage bond regulations do not overstep legislative bounds.

Mr. Chairman, PSA is pleased to hear that the Treasury and IRS will soon be issuing rulemaking proposals that will respond to the concerns that have been expressed by the PSA and other participants in the municipal securities market over the May 8 regulations concerning arbitrage bonds.

We can only hope that the new proposals will be consistent with what we believe the Congress intended in enacting the arbitrage bond statute and will be more narrowly targeted than the May 8 proposals.

We believe that Treasury's action will be consistent with the requests for withdrawal and/or substantial modification of the May regulations and hope that it will address not only the concerns over the invested sinking fund regulation, but will respond to concerns over the proposed changes in the certification procedure, in the treatment of issuers' administrative costs, and Treasury's ability to define artifices and devices and the fair market value on bond sales.

We hope that the proposed regulations will, in fact, be proposed in accordance with good rulemaking practices and will allow for public commentary before they become effective.

Since we do not have the new regulatory proposals before us to evalute, we cannot fully support the Treasury at this time.

We would, however, be opposed to any efforts to patch up the May 8 regulations in a piecemeal fashion through a series of revenue rulings.

If Secretary Lubick holds true to his word, then we believe that remedial legislation may not be necessary and this committee will immeasurably have assisted the State and local government.

I also wonder, since the Treasury is willing to accept credit for the decline in the rates after December's announcement, if it will also accept credit for the increase in rates since the May 8 announcement.

We thank you for your interest and your efforts in this area. In view of the fact that we have no revised regulations before us, we request that PSA's prepared statement, which includes our analysis of the May regulations and our comments to Treasury, be included in the record. We will be very happy to submit any additional comments or do any additional work in this area to assist this committee and the Treasury in the procedure along the lines of getting those proposals and regulations into effect.

Thank you very much, Mr. Chairman.

Senator BENTSEN. We would be pleased to have those. Thank you, sir.

[The prepared statement of Mr. Chambers follows:]

STATEMENT OF WALTER R. CHAMBERS, CHAIRMAN OF THE PUBLIC SECURITIES ASSOCIATION

Mr. Chairman and members of this distinguished committee, the Public Securities Association is pleased to have this opportunity to present its views concerning the Treasury Department's proposed amendments to the arbitrage bond regulations that were published on May 8, 1978. PSA is a national trade association representing some 260 dealers and dealer banks which provide underwriting and financial advisory services for state and local governments. In 1977, PSA members participated in approximately 80 percent of the underwritings of new issue muncipal securities that came to market.

PSA offers its comments concerning the proposed arbitrage bond regulations from the perspective of its members as participants in the tax-exempt market. We have submitted detailed comments on the proposed regulations to the Treasury and the Internal Revenue Service and have urged withdrawal of the May 8th proposals in our letters and in our testimony at a public hearing on July 25, 1978. Copies of PSA's letters on the subject are attached to this statement and we request that they be included in the record for this hearing. We hope that our comments will assist this Committee as it considers what steps should be taken to ensure that the arbitrage bond regulations do not overstep legislative bounds.

We are also fully aware that this Committee has before it a bill introduced by Senator Bentsen which, among other things, would validate the May 8th proposals and would prohibit the issuance of any arbitrage regulations in proposed or final form from the period beginning on August 1, 1978 and ending on December 31, 1979, from the standpoint of the Treasury Department, this must indeed be viewed as an ominous legislative proposal—in effect, it would impose a moratorium on the issuance of regulations under Section 103(c) of the Internal Revenue Code.

PSA has not yet adopted a formal position on this kind of measure. However, I would like to state a proposition which, in our opinion should be the Committee's underlying consideration with respect to Senator Bentsen's legislation. That is, if the Congress determines that the manner in which the May 8th regulations have been issued has not effectively carried out the purposes of the arbitrage bond statute, and fundamental rights of state and local governments have thereby been adversely affected—then we think the thrust of Senator Bentsen's bill is appropriate.

Briefly stated, Mr. Chairman, our position is that the proposed new regulations will work an unwarranted hardship on state and local governments and will undermine the confidence of the market with respect to the tax-exempt status of municipal securities.

The May 8th Notice of Proposed Rulemaking issued with the proposed regulations states that the new regulations are "designed to clarify and correct" the existing arbitrage bond regulations. The Notice also characterizes the use of invested sinking funds by state and local governments as an "abuse" and the new regulations prohibit this practice.

In addition to prohibiting this practice, the proposed regulations would materially change the procedure whereby state and local government issuers certify that obligations will not be arbitrage bonds, and, secondly, would eliminate the current system under which issuers use investment income to recover a wide variety of financing costs. I will be summarizing our specific items of concern regarding the substance of these new regulations. However, we believe it is equally important to note that Treasury and the Internal Revenue Service have not provided a detailed statement of the reasoning and rationale for changing the certification procedure or eliminating the mechanism for recovering costs. Unless Treasury and IRS offer a clear basis for regulatory change, we submit that the existing practices in both of these areas—which from our perspective are working exceedingly well—should remain in place.

It is our belief that the record established in the many comment letters submitted and in the testimony presented at the public hearing on July 25th provides ample justification for the withdrawal of the May 8th proposals. This would enable Treasury and the Internal Revenue Service to develop regulations that would implement the purposes of the arbitrage bond statute without creating unnecessary burdens on market participants. However, we recognize that remedial legislative action may be required to suspend the effectiveness of the regulations if it does not appear that responsive administrative action will be taken.

I will now summarize PSA's major concerns with the proposed regulations.

CERTIFICATION PROCEDURE

It is our opinion that the proposed changes in the existing arbitrage certification procedure will have the most unsettling impact on the municipal securities market. The current certification procedure was developed by Treasury and IRS in 1972 at the request of state and local government issuers. Its objective was to provide investors with a certification they could conclusively rely on that the proceeds of an issue would not be used in a manner that would cause the obligations to be arbitrage bonds.

The efficacy of this procedure will be drastically limited under the new regulations. First, issuers will not be able to certify that the proceeds of an issue will not be used in a manner that will cause the obligations to be arbitrage bonds. Secondly, the express authorization under which investors can conclusively rely on an issuer's certification has been eliminated.

We believe that the amendments proposed to the certification procedure will unnecessarily complicate certifications by requiring more detailed factual statements concerning future events while at the same time limiting the conclusiveness and reliability of issuer's certificates. This erosion of the certification procedure has a very real potential for causing an increase in yields necessary to sell state and local government obligations.

The proposed regulations contain an example which illustrates the potential impact of this new rule on investors. The example involves a bond issue in which a certification has been given as required under the new regulations and a legal opinion has been rendered that the bonds are not arbitrage bonds. Yet, the bonds will be arbitrage bonds—and therefore taxable in the hands of investors—upon the determination by IRS at some later date that an "artifice or device" was used which enabled the issuer to exploit the difference between the tax-exempt and taxable interest rates.

Under this ambiguous "artifice or device" example, Treasury or IRS could effectively define what constitutes an arbitrage bond on a case-by-case basis. The determination that an issue of bonds is taxable as a result of the application of this vague standard would disrupt the market and could involve all affected parties in complex legal proceedings. Significantly, when the senate considered the arbitrage bond legislation in 1969, it revised the house bill to remove the authority granted to treasury to define the term "arbitrage bond" by regulation and adopted a statutory definition of the term. Based on the legislative history of the arbitrage statute, we submit that Treasury and IRS were never intended to have the broad authority created by the "artifice or device" rule.

Existing regulations have a procedure which enables IRS to disqualify an issuer as to future certifications if the issuer has given a certification containing a material misrepresentation. We believe this procedure is adequate to prevent abuses, without penalizing bondholders by having bonds declared taxable.

TREATMENT OF ISSUERS' ADMINISTRATIVE COSTS

The treatment of issuers' administrative costs in computing permissible yields for arbitrage purposes that will become effective on September 1 will deny issuers the right to use investment income to recover a wide variety of financing costs typically incurred. The result will necessarily be that issuers will be forced to choose investments producing artificially low yields, which, in turn, will result in windfall gains to the sellers of invstment obligations. The principal beneficiary of the new regulations will be the Treasury Department, which provides Treasury securities which are, in effect, tailor-made for purchase by state and local governments.

We believe that the proposed requirement that yield be computed by using the price at which bonds are sold to investors (unless that price is "unreasonably low"), rather than the price at which bonds are sold to the underwriters, fails to reflect economic reality. This requirement would be directly contrary to existing practice under the arbitrage bond statute and regulations.

Moreover, the proposed requirement to substitute "fair market value" for purposes of yield computations if the purchase price paid by investors for the bonds is "unreasonably low" is ambiguous at best. The regulations provide no indication as to what should be considered "unreasonably low" or how "fair market value" should be computed. These vague standards will introduce additional uncertainties into the marketplace which will result in higher borrowing costs for state and local government programs.

The proposed treatment of costs of municipal financing, although apparently intended to restrict refundings, will have broad application to all types of issues. This will impose particular hardship on governmental issuers such as housing finance agencies whose purpose is to provide reasonably-priced housing for low and moderate income families.

As we have pointed out in our letters of June 7th and June 28th to the Treasury, the unfairness and uncertainties involved with this proposal are forcing many issuers to come to market prior to September 1st, to avoid losses that would be forced on them after that date. It is our opinion that this increased financing activity has an unnecessary adverse effect on the municipal securities market.

LIMITATION ON INVESTMENT OF STATE AND LOCAL REVENUES

Another area of concern to PSA are the new rules already effective which broadly define a sinking fund to include a debt service fund or any similar fund to the extent an issuer reasonably expects to use the fund to pay principal or interest on the issue. These provisions are not limited to the refunding context or to the recent practice involving invested sinking funds. Specifically, they provide that taxes or other revenues of state and local governments will be subject to arbitrage limitations even though these revenues are not derived from the sale of bonds.

We recognize that the IRS announced two new revenue rulings yesterday afternoon relating to the arbitrage bond statute and the proposed regulations. Upon initial analysis, it would appear that one of these rulings responds to concerns created by the overly-broad regulations and a July 20th revenue ruling relating invested sinking funds. We do, however, question this rulemaking practice of, in effect, amending regulations which may have no valid statutory basis by subsequent rulings.

In our comment letter of June 28th we have described several examples of municipal financing arrangements where accumulations of taxes or other revenues for periods in excess of the limited investment periods permitted under the May 8th regulations may be required by legal or practical considerations. Other types of issues affected, including that of tax-exempt hospital financing and tax allocation financing by redevelopment agencies in several states, have come to our attention. At the very least, many issures will be confronted with drafting and accounting problems resulting in increased costs of issuance.

We believe that Congress, by enacting the arbitrage bond statute, intended only to limit the investment of monies derived from the sale of debt obligations not the investment of state and local revenues. This restriction should be modified in accordance with the intent of Congress to be targeted to any real abuses that may exist. If it is not so modified, this overly broad rule, considered together with the proposed weakened certification procedure and the example of bonds being declared taxable because of the use of an "artifice or device", will result in greater caution on the part of investors and increased costs for issuers of state and local government obligations.

CONCLUSIONS

We believe that the proposed regulations, taken as a whole, represent an unwarranted departure from accepted practices which is not supported by the statute or legislative history. The widespread opposition to these regulations indicates that these proposals go beyond what is necessary to curb identified abuses and "clarify and correct" existing regulations as was stated in the May 8th notice of proposed rulemaking.

In any event, we are concerned over the short and long-term effects of this type of administrative action on the municipal securities market. This piecemeal approach to developing regulations under the arbitrage bond statute has resulted in a complex body of rules that exist in proposed form nine years after enactment of the statute. Accordingly, we have recommended that the May 8th proposals be withdrawn.

As I stated at the outset, we believe that it is appropriate for the Congress to consider whether the Treasury and IRS have overstepped legislative bounds in adopting the May 8th arbitrage regulations. It may well be that this Committee and the Congress will determine that remedial legislative action is necessary to ensure that the fundamental rights of state and local governments are protected.

In any event, we do not believe that significant concerns of PSA and other market participants will be, or should be, responded to in a piecemeal fashion by a series of interpretive revenue rulings. This, we believe, is inconsistent with good rulemaking practices.

PUBLIC SECURITIES ASSOCIATION,
ONE WORLD TRADE CENTER,
New York, N.Y. August 9, 1978.

Re Proposed Arbitrage Bond Regulations of May 8, 1978.

Hon. W. MICHAEL BLUMENTHAL,
Secretary of the Treasury,
U.S. Department of the Treasury,
Washington, D.C.

DEAR SECRETARY BLUMENTHAL: The Public Securities Association (PSA) wishes to reiterate its concern over the Treasury Department's proposed regulations relating to arbitrage bonds issued on May 8, 1978, a concern which is shared by state and local governments and other participants in the municipal securities market. We therefore repeat our request that the proposed regulations be withdrawn (or at the very least that the Treasury Department and the Internal Revenue Service (IRS) to develop regulations within the scope of authority granted by Section 103(c) of the Internal Revenue Code to deal with identified abuses.

A representative of PSA appeared and presented testimony at the July 25, 1978 public hearing held by the Treasury and IRS with regard to the May 8 proposals. More than thirty other representatives of participants in the municipal securities market appeared at that hearing to express their opposition to the proposed regulations. These appearances by concerned state and local officials and other interested parties were in addition to the scores of comment letters that have been submitted in opposition to the proposed regulations. To our knowledge, there has not been a statement made or comment letter submitted in support of the proposals. Rather, those commenting appear to agree unanimously that the proposed regulations are inconsistent with the intent of Congress as expressed in the arbitrage bond statute and its legislative history and will create unwarranted hardship on issuers of municipal securities.

We note that Senator Floyd K. Haskell has urged Treasury to defer final action on the proposed regulations and Senator Lloyd Bentsen has introduced a bill (S. 3379) that would suspend the regulations in question and any future regulations relating to arbitrage bonds until the end of 1979 to enable the Congress to carefully review the entire issue and make appropriate policy decisions. As we stated at the public hearing of July 25th, PSA continues to believe that effective administrative action can be taken. We believe that the widespread public criticism and the record established with respect to the May 8th proposals make it clear that the rulemaking approach embodied in those regulations is unsound and inconsistent with the President's Executive Order of March 23, 1978 on improving government regulations. Accordingly, we recommend withdrawal of the proposed regulations, pending a comprehensive review of the arbitrage bond regulations, which now exist in proposed form nine years after enactment of the statute, in accordance with the Treasury Department's plan for implementing the President's Executive Order.

Very truly yours,

WALTER R. CHAMBERS, *Chairman.*

PUBLIC SECURITIES ASSOCIATION,
ONE WORLD TRADE CENTER,
New York, N.Y., June 28, 1978.

Re Proposed Amendments of May 8, 1978 to Income Tax Regulations Under Section 103(c) of the Internal Revenue Code of 1954 Relating to Arbitrage Bonds (43 Fed. Reg. 19675)

Hon. JEROME KURTZ,
Commissioner, Internal Revenue Service,
Washington, D.C.

DEAR COMMISSIONER KURTZ: The Public Securities Association (PSA), a national trade association representing some 250 dealers and dealer banks which provide underwriting and financial advisory services for state and local governments, hereby submits its comments regarding the proposed amendments to arbitrage bond regulations published on May 8, 1978. In addition, PSA requests an opportunity to make an oral presentation of its views with respect to the proposed amendments at the scheduled public hearing of the Internal Revenue Service (IRS) on July 25, 1978.

As you will not in the attached letter of June 7, 1978, to Secretary of the Treasury Blumenthal, PSA believes that because of the uncertainties caused by the proposed regulations there will be a substantial increase in the number of state and local government issues coming to market prior to September 1, 1978, the effective date of many of the provisions contained in the proposed amendments. In our opinion, this increased market activity will result in significantly higher interest rates for borrowers and cause a disruption of capital markets, similar to that which was precipitated by the May 15 deadline on the invested sinking fund provisions. In view of the broad scope of the provisions becoming effective on September 1, we are reiterating our request that consideration be given to postponing the September 1, 1978 effective date.

PSA's specific comments relating to the May 8, 1978 proposals are as follows:

Scope and regulatory basis of the proposed regulations

The May 8, 1978 Notice of Proposed Rulemaking (the Notice) in connection with the proposed amendments states that the new regulations are "designed to clarfiy and correct" the existing arbitrage bond regulations. The Notice also characterizes as an "abuse" an issuer practice whereby contributions of taxes or other revenues are made to a sinking fund which is invested without yield restriction. This practice, subject to certain exceptions, is prohibited in connection with all obligations sold after May 15, 1978 under the rulemaking proposals set forth in the Notice.

It is our opinion that the new regulations, in addition to setting forth clarifications and corrections and a prohibition of a certain practice, promulgate, in effect, an entirely new regulatory approach with respect to (a) the certification procedure (unde Section 1.103-13(a)(2) of the arbitrations regulations) and (b) the manner in which issuer's administrative costs may be treated in connection with yield computation. This new approach is broadly applicable to all state and local government financings, including general obligation bonds, revenue bonds and refunding issues.

As discussed below, we believe the proposed regulations in question are, in certain instances, inconsistent with the intent of Congress as expressed in Section 103(c) of the Internal Revenue Code of 1954 (the Code) and, taken as a whole, are likely to adversely affect the municipal securities market and its participants. Therefore, we submit that unless the following basic criteria are met the proposed new regulations should not be adopted:

(1) The new regulations must be clearly consistent with the stated purposes of Section 103(c) of the Code and the intent of Congress in enacting that provision;

(ii) Well-established regulations should not be repealed (and accepted practices thereunder disturbed) unless a clear need and adequate statutory basis for their repeal are demonstrated; and

(iii) The efficacy of new proposed regulations should be determined prior to their adoption (i.e., there must be a determination that the proposals are confined to the demonstrated need and are workable and capable of being implemented by market participants without material disruptions of accepted practices).

Certification procedure

PSA believes that the changes proposed in the arbitrage certification procedure may have the most unsettling impact on the municipal securities market. The application of the statute depends upon an issuer's "reasonable expectations" with respect to a bond issue. Thus, Congress has established a standard which is obviously difficult to apply with any certainty since expectations may not be borne out and may be questioned retrospectively from the standpoint of reasonableness.

Faced with highly complex regulation and the need to determine reasonable expectations in a manner that would provide market confidence, issuers in 1972 requested that Treasury and IRS provide a form of certification which could be conclusively relied on by investors to demonstrate that obligations were not arbitrage bonds. The purpose was to avoid the hazard that the market would discount the value of tax exemption because of the great uncertainties involved in determining "reasonable expectations". The Treasury and IRS responded to this request by carefully working out the current procedure under which an issuer may certify, based on relevant facts, estimates and circumstances, including the issuer's covenants, that proceeds of the issue will not be used in a manner that would cause the obligation to be arbitrage bonds. Absent any "blacklist", the current regulations provide that holders of such obligations may "conclusively rely" on that certification.

For obligations issued after September 1, 1978, however, the new regulations will substantially limit the efficacy of this procedure. First, issuers will be prohibited from certifying that the proceeds of an issue will not be used in a manner that would cause the obligations to be arbitrage bonds. Secondly, the express authorization under which investors can conclusively rely on an issuers certification has been eliminated. These are fundamental changes which very substantially undercut the current certification procedure. The new regulations ignore the basic need to provide investors with reasonable assurance as to an issue's tax exemption, a need that was correctly understood by Treasury and the IRS when the present procedure was devised. Neither market circumstances nor the applicable law have changed since then, and it is thus difficult to perceive why changes are now proposed in a workable procedure that has gained wide acceptance and has provided stability to the municipal market.

The proposed regulations provide that issuers may certify only as to future events, not conclusions of law, "including legal characterizations of future events." The regulations are ambiguous as to how this rule is to apply, and in many cases it will be most difficult to draw distinctions between matters of fact and conclusions of law.

Another change involves the deletion of any express reference to the issuer's covenants. While issuers are frequently subject to broad covenants against arbitrage, there is now a question whether under the proposed regulations such a covenant can serve as a basis for certification. Thus, the issuer may be denied the benefit from use of this covenant, which has become common practice in order to help assure bond purchasers as to the tax-exempt status of the bonds.

As certificates become exhaustive in factual detail and all parties become increasingly cautious, there is a real potential that the yields necessary to sell municipal obligations will rise, since the predictability and certainty heretofore available to investors will have been eroded. PSA believes that such a serious effect on the market for tax-exempt securities is not justified, and that the effort to drastically change the present certification procedure should be abandoned.

The reliability of the arbitrage certificate has been further eroded by Example (4) of the proposed regulations. Although this example involves a refunding issue, it is far from clear that the rule would be limited to refundings. It provides that even though a certificate has been given in the manner required by the new regulation and there is a legal opinion that the bonds are not arbitrage bonds, the obligations will nevertheless be treated as arbitrage bonds if any "artifice or device" is used "to exploit the difference between the tax-exempt and taxable interest rates" and it serves as a "material inducement" to the issuance, amount or maturities of the bonds. If applied generally, the "artifice or device" example can supplant the entirety of the law and regulations and leaves little basis for assurance of tax exemption because there is no guidance given as to what is an "artifice or device" and, therefore, no way to ascertain whether one is being used. Without any indication as to what was intended, the regulation will cast doubts in the market place on many situations which would not normally be thought of as motivated by arbitrage.

Significantly, in 1969 when the Senate considered the arbitrage bond legislation it revised the House bill to remove the regulatory authority granted the Treasury to define "arbitrage bond" ano, instead, inserted an express statutory definition. Under the proposed new regulation, however, IRS could administratively define and redefine "artifice or device" and, in effect, substantially change the statutory definition of "arbitrage bonds." Based on the 1969 legislative history, PSA submits that there is a serious question whether Treasury and IRS were ever intended to have the broad authority created by the new regulations, particularly in light of the uncertainties, significant compliance costs and potentially higher interest costs which are likely to result.

Treatment of issuers' administrative costs

Under the May 8 proposals issuers will be denied the right to use investment income to recover a wide variety of financing costs they typically incur. Heretofore, the question has been how to take into account the costs of issuing, carrying and repaying debt obligations and of purchasing carrying and selling investment securities. Effective September 1, however, all of those actual costs are to be disregarded in computing yield. Resulting lower computed yields on the bonds and higher computed yields on investments will force issuers to choose investments producing artificially low yields, resulting in windfall gains to sellers (principally the Treasury) of obligations acquired for investment purposes by state and local governments.

Secondly, by requiring that yield be computed by using the price at which bonds are sold to investors (unless it is "unreasonably low"), instead of the sales price to underwriters, the regulations ignore the reality of the transaction and attribute the underwriter's discount to the issuer, again forcing the issuer to accept artifically low investment yields and thus preventing recovery of real costs of financing. By excluding the customary underwriter's discount in computing investment yield, the regulations ignore a fixed cost which is an essential part of the pricing mechanism for many municipal obligations. This regulatory proposal simply fails to reflect economic reality and is directly contrary to prior practice under the arbitrage bond statute and regulations.

Finally, the proposed regulations require that if the purchase-price paid by the investor for the bonds is "unreasonably low", then the fair market value is to be substituted for purposes of yield computations. No indication is given as to what will be considered "unreasonably low" or how fair market value should be computed. This vague requirement, coupled with the reduced efficacy of the certification procedure, will create greater uncertainties for issuers in determining permissible investment yields. These uncertainties will be shared by other market participants and will likely result in higher borrowing costs for state and local governments.

The need to determine the initial offering price or price to the first buyer, whether it is unreasonably low and what the fair market value of the obligations will be, at a minimum will be burdensome and costly to issuers who do not, themselves, have the kind of information necessary to make such determinations or the expertise to evaluate it. The effect of the new provisions will be to force losses upon issuers by preventing the recovery of actual costs incurred. In the context of a statute aimed at limiting arbitrage profits, there is no evidence—and no logical reason—why Congress would want to ignore actual costs or, in effect, to attribute an underwriter's profit to an issuer.

Limitation on investment of State and local revenues

In general, for obligations sold after May 2, the new regulations provide that amounts "accumulated" in a "sinking fund" for an issue are treated as proceeds of the issue. "Sinking fund" is, in turn, broadly defined to include ". . . a debt service fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the issue." Thus, tax or other revenues of any governmental unit may be subject to the arbitrage limitations even though such amounts are not derived from the sale of bonds. The restrictions will not apply, however, if the revenues are invested for a temporary period or, together with other proceeds, do not exceed the 15 percent "reasonably required reserve or replacement fund" or "minor portion" (where applicable).

This broad regulation, which, by its terms, is already effective, is not confined to the refunding context nor is it limited to situations where the investment of the revenues is contracted for in advance, as in the recent practice with invested sinking funds. No provision is made for excluding a general debt service fund or a bond retirement fund created by statute for all general obligations issued by a governmental unit. Similarly, there is no explicit provision for allocating monies in a fund among the various issues whose debt service may be paid from the fund. Finally, while a more liberal temporary 13 month investment period is permitted for a "bona fide debt service fund", no guidance is given for distinguishing that fund from a sinking fund subject to the maximum thirty-day temporary period for investment without yield limitations.

These omissions indicate a lack of the careful consideration which is necessary to the promulgation of regulations affecting very important functions of state and local governments.

There are many situations in municipal financing arrangements where accumulations of taxes or other revenues may be necessary to meet legal requirements or practical needs. In many cases, due to such requirements beyond the control of issuers, taxes or other revenues will be accumulated in a debt service fund for periods exceeding 13 months, and it will be necessary to restrict yield when the revenues are invested (assuming the 15 percent leeway is not available). Some typical examples (there are many others) illustrating the magnitude of this problem are:

(*a*) Special assessments are levied to pay the total debt service on a bond issue. Commonly, significant portions of assessments are prepaid after the bonds are issued and such amounts may be held in the fund for more than 13 months before being applied to pay debt service. Under the new regulations, it will be necessary to restrict the yield on the investment of these amounts.

(*b*) Debt service on an issue of bonds sold to acquire a municipal utility system will be paid from a fund consisting of user charges. During the term of a bond issue, there may be significant changes in the use of and expense of operating the system, thereby causing significant changes in the level of receipts available for debt service from year to year. Users charges not paid out of the fund within 13 months of receipt will have to be subject to investment yield restrictions.

(*c*) Property taxes are levied to pay debt services on a bond issue. If no tax delinquencies occurred, the rate of tax would be set at X percent. In order to at 1.07•X%. If few tax delinquencies in fact occur, some taxes will be held in guard against possible delinquencies, however, the percentage is set, for example, the debt service fund for periods exceeding 13 months, and investment yield restrictions will therefore apply.

(*d*) Certain revenues of a housing finance agency pledged to debt service consist of payments made on residential mortgage loans, including loan prepayments and payments of insurance to cover defaulted loans. Depending on the amount of such payments received by the agencies and the amount of new residential loans it approves, the receipts might not be withdrawn from the fund within 13 months and thus would be subject to investment yield restrictions.

The plain meaning of the arbitrage bond statute and the legislative history make it clear that Congress intended only to limit the investment of monies derived from the sale of debt obligations, not the investment of state and local revenues. The tax-writing Committees gave the following reason for enacting the statutory limitation:

"Some State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the *funds from tax-exempt issues* are employed to purchase higher yielding Federal obligations whose interest is not taxed in their hands." (H. Rep. No. 41-413, 91st Cong. 1st Sess. 173, S. Rep. No. 91-552, 91st Cong. 1st Sess. 219.) (emphasis added)

In a memorandum to the Senate Finance Committee the Treasury described the problem as follows:

"Some state and localities have used *funds received from the issuance by them of tax exempt bonds* to purchase higher yield taxable securities." (emphasis added)

In view of this clear evidence of the intent of Congress and the Treasury in 1969, PSA believes that broadening the scope of the statute by regulation—9 years after its enactment—to include various revenues of the issuer is an erroneous interpretation of the law. PSA notes in this connection that in June of 1972 the Treasury issued proposed regulations treating revenues from a project financed with bonds as "proceeds" for purposes of the arbitrage limitations. After receiving considerable adverse commentary questioning the validity of this proposal the Secretary of the Treasury announced its withdrawal in August of 1972.

These new regulations will substantially restrict municipal issuers in the prudent management of their revenues and their debt and will involve the Treasury and IRS in the most basic fiscal concerns of state and local governments, e.g., investing and allocating revenues, scheduling debt retirement, establishing safeguards against revenue declines, providing debt coverage, and determining tax and utility rates. In PSA's judgment the current protection afforded to investors in municipal securities will be significantly reduced if the scope of the regulation is not narrowed substantially. If issuers are denied the right to invest revenues held in debt service or similar funds at market rates, they will likely reduce the size of such funds as much as possible, thereby reducing the security such funds afford investors.

Conclusion

PSA believes that the proposed regulations, taken as a whole, represent an unwarranted reversal of accepted and workable methods of determining yield limitations which in some respects has no basis in the statute or legislative history. We are deeply concerned that this major reversal of policy which is described in the May 8, 1978 notice as being merely "designed to clarify and correct the regulation" will substantially weaken the certification procedures and make arbitrage determinations unnecessarily complex and costly.

Moreover, PSA is concerned that the recent efforts of Treasury and IRS to restrict the use of refunding issues will effectively preclude their use for legitimate purposes. We see no intent by Congress in enacting the arbitrage statute to so severely limit the use of a long-recognized tool of state and local government financial management.

It is our belief that the proposed new regulations will work an unwarranted hardship on issuers and undermine the confidence of the market with respect to the tax exempt status of municipal securities. Accordingly, PSA urges withdrawal of the proposed regulations to enable Treasury and IRS to develop, after consultation with interested parties, regulations reasonably related to any real abuses that may exist. At the very least, we believe that the September 1, 1978 effective date should be postponed in accordance with our request of June 7th to avoid adverse market consequences.

Very truly yours,

WALTER R. CHAMBERS, *Chairman.*

Enclosure.

PUBLIC SECURITIES ASSOCIATION,
ONE WORLD TRADE CENTER,
New York, N. Y., June 7, 1978.

Re Proposed Arbitrage Bond Regulations.

Hon. W. MICHAEL BLUMENTHAL,
Secretary of the Treasury,
U.S. Department of the Treasury.
Washington, D.C.

DEAR SECRETARY BLUMENTHAL: The Public Securities Association (PSA) is currently reviewing the Treasury Department's proposed regulations relating to arbitrage bonds issued on May 8, 1978. We are generally concerned that the May 8 proposals may go beyond the trust of Section 103(c) of the Internal Revenue Code, which limits the permissible yield on investment of proceeds from the sale of municipal bonds. Consequently, it is our initial opinion that the proposed regulations, if adopted, could impair the ability of the state and local governments to manage their revenues and their debt in an efficient and effective manner and could create uncertainties for all participants in the municipal securities market.

Although PSA will be commenting further on the proposed regulations, our immediate concern is that the May 8 proposals will have a harmful effect on the municipal securities market in the very near future. Because of the broad sweep of the proposed regulations and the substantial uncertainties that will result for all market participants if the proposals are adopted, we believe that the issuers will deem it in their interests to issue bonds prior to September 1, 1978, the date on which all of the new regulations are to become effective. Thus, we believe it is reasonable to project that during the period between now and September 1, 1978 there will be a substantial increase in the number of state and local government issues which, in turn, will result in significantly higher interest rates for borrowers and cause a disruption of the capital markets.

Out of a concern for an orderly market PSA respectfully requests that consideration be given to the postponement of the September 1, 1978 effective date of the regulations. This action would preclude the creation of unnecessarily disruptive pressures to issue debt hastily to avoid the impact of the proposed regutions and would permit the development by Treasury, with the opportunity for consultation with interested parties, of regulations reasonably related to any real abuses that may exist.

Finally, PSA would be pleased to respond to any questions you or your staff may have regarding the market problem discussed above.

Very truly yours,

WALTER R. CHAMBERS, *Chairman.*

Senator BENTSEN. Our next witnesses will be a panel composed of Mr. Jack Giberson, chief clerk, General Land Office, State of Texas, and Mr. John M. Urie, financial director of the city of Kansas City, Mo.

STATEMENT OF JACK GIBERSON, CHIEF CLERK, GENERAL LAND OFFICE, STATE OF TEXAS

Mr. GIBERSON. Mr. Chairman, I am not fully familiar with your panel procedure. Am I permitted to give my presentation? I am Jack Giberson.

Senator BENTSEN. Yes; of course. That is the purpose of your being here. Please make your statement and then any questions that might be warranted afterwards will be asked.

Mr. GIBERSON. Thank you, Mr. Chairman.

As pointed out in my written speech, my name is Jack Giberson and I am chief clerk of the general land office, or what might be referred to as deputy land commissioner. I have occupied this position for some 18 years. The reason I point this out is I am not trying to impress you with my pedigree or record, but I just want you to know that I am familiar with the programs in the State of Texas.

We have several ongoing programs in the State of Texas that depend on the sale of tax free bonds. All these various programs are different.

One of the programs is a veterans land program. We administer that program in the General Land Office of the State of Texas. If you are familiar with the history of the State of Texas, you will know that after each battle, after the battle of the Alamo, after the battle of San Jacinto, after the various wars, Texas gave her veterans land, free land. These veterans answered the call of freedom. When we needed the veterans to fight against the enemy, they came forth and fought.

So, as a result of that, Texas has awarded those veterans a piece of the land that they fought to preserve and to protect.

After World War II, we were out of public land, so we did the next best thing. The legislature, in its foresight passed legislation that would permit the veterans to borrow money at a low rate of interest and pay for the land over a 40-year period with a 5-percent down payment.

Now, it took a constitutional amendment to put this in effect. The people of Texas have supported this program throughout the years. They have approved constitutional amendments five times. They have authorized the sale of $700 million worth of bonds.

To date, we have sold $525 million worth of bonds, and we have bought 3.5 million acreas in Texas. We have bought land for 63,000 Texas veterans. This is a continuing and ongoing program.

Or real problem was pointed out by the Assistant Secretary of IRS. He pointed out that in your sinking fund, you could retain 15 percent of your outstanding bonds—in your sinking fund. We have $300 million in outstanding bonds. But our sinking fund is made up of money that the veterans pay in each 6 months on their contracts. Our bonds are not due. They are not mature.

So, what we do with that sinking fund is this. We invest it in Government securities. This money is used to pay back our bondholders. It far exceeds 15 percent. This is our ongoing program in Texas. Without this ability we could not have a veterans land program. This program would be dead, because the only features of this program that are attractive are the facts that we have a low down payment and a very low interest rate. For us to have this low interest rate, we have to be able to invest the sinking fund in Government securities and use this money to pay back our bondholders.

We are also required, as a matter of contract, to keep some $40 million in reserve. That is a contractual obligation that we have with the bond purchaser. So, this runs our fund up to some $200 million.

Now I realize that these are moneys that we have under the past regulation. But we are going to continue this program. We are authorized to sell another $175 million worth of bonds and if these regulations are effective and they don't work out some agreement with us, then this program in Texas will be stymied to the extent that it won't be worthwhile to continue our veterans land program.

I agree with Senator Haskell. I think he made a very critical point when he said that it seems to him—and I am not trying to quote him—generally he said that this is legislation without representation: when IRS comes along and makes rules and policies without having proper representation from the people. That is what exists. I think they are making rules and policy that have the effect of law.

You know, in Texas we kind of laugh about this. When you can't do things in accordance with law, then you make a rulemaking power. We try not to do that in the General Land Office, but I have heard that some other State agencies do that.

So, we are opposed to this, I have been in the Land Office long enough to know that we hate to wake up every morning in fear that our veterans land program is going to be stymied or killed by new regulations that take place. If they trade out today, then what is going to happen tomorrow, and tomorrow, and tomorrow. These are the problems that we think exist, and this is why we are concerned.

I thank you for your legislation and your support of our cause.

Senator BENTSEN. Thank you very much for your testimony. I have substantial familiarity with the Texas veterans program which helps them buy land. It has been a great boon to an awful lot of veterans.

Mr. GIBERSON. Thank you.
[The prepared statement of Mr. Giberson follows:]

STATEMENT OF JACK GIBERSON

Mr. Chairman, members of the Committee, my name is Jack Giberson. I am Chief Clerk of the General Land Office of the State of Texas, which position is Deputy Land Commissioner of the State of Texas. I have occupied this position for some 18 years and been in the General Land Office 25 years. I am here on behalf of the people of Texas, the State government of Texas and particularly the Texas Committee for the Prevention of Federal Encroachment Upon Public Finance which is composed of most of the agencies of the State of Texas and a great number of the major issues of municipal debt in the State of Texas, pertaining to rules and regulations and policies that have been promulgated by the Treasury Department and the Internal Revenue Service pursuant to section 103(c) of the Internal Revenue Code of 1954, as amended. These rules, regulations and policies give us great concern in Texas. We have a number of programs in Texas that depend on the sale of tax-free bonds and the freedom to sell these bonds and invest the money in programs that are beneficial to the people and to the State of Texas. One of the programs is the Veterans Land Program which is administered through the General Land Office of the State of Texas. This program, in existence since 1949, has been continued and enlarged through several constitutional amendments, the most recent approved by the Texas electors last year.

It was historically the policy of the State of Texas to reward its veterans through the gift of land. The reason land was given to the veterans was because it was felt that the veterans of Texas should be rewarded for answering the call of freedom and coming forth and fighting for the protection of the people of Texas and the United States. It was not the policy to grant small, token sums of money that could be spent overnight, but to give them something worthwhile. Since Texas is now out of public lands, or has disposed of most of her public lands, it is felt that the way to reward veterans is to make it possible for them to buy a piece of land at a low rate of interest, with payments over a 40-year period and a 5% down payment. Up to the present time, over 68,000 veterans have bought over 3½ million acres of land through the program. At this time, over one million veterans in the State of Texas are eligible to participate in the program if it can be continued under the subject regulations. Over 200 of these transactions are closed each month and it is anticipated that this program will continue for years to come. It has been necessary for us to sell some $525 million worth of bonds to finance this program of which over $300 million are now outstanding and we're authorized by our Constitution to issue an additional $175 million worth of bonds. We presently have in our debt service fund, from moneys received from repayments on land contracts, over $156 million.

These moneys are invested and, with the accumulated interest, are used to pay back our bond holders and establish the necessary operating reserves to maintain the fiscal integrity of the program and to ensure the continued ability of the State to issue additional authorized bonds. In addition to the moneys held in the debt service funds, we must have some $40 million in our reserve fund. This reserve fund, established by the bond resolution and mandated by the Texas Constitution must contain funds equal to 8% of the outstanding bonds. This $40 million is also invested. Due to the nature of the program, it is necessary to hold money in the debt service fund in excess of 13 months. This is composed of money that is derived from repayments on land contracts. It has nothing to do with bond proceeds. However, the Treasury Department at this late date in history, proposes to tell the Veterans Land Board at what rates certain moneys in the Veterans Land Fund can be invested. The reason, Mr. Chairman and members of the Committee, that we are deeply interested in this bill is that we feel that the current rules and regulations, if carried forward, would stymie our program. It might mean the death of our program, along with other similar programs of the State of Texas. These are of great benefit to the State and its economy and to the people of the State of Texas and include, among others, our water programs, our coordinating bond program for colleges, and also our Veterans Land Program. We feel that the May 8 regulations would be most detrimental to the Veterans Land Program and the other State programs. We also feel that it was not the intent of Congress to permit the Treasury Department or any other government agency to legislate. We feel that when Congressmen, the Senators and

Congressmen from Texas or any other state were elected, they were representative of the people and the laws should be passed by them. We don't want IRS or any other agency having the ability to make rules, policies and law without proper representation. We think that this should be retained by the Congress. We're up here in support of Senator Bentsen's bill, S. 3370, and urge the Congress to vote in favor of this bill for the protection of the people of Texas and the people of the United States.

Senator BENTSEN. Mr. Urie, would you now please testify.

STATEMENT OF JOHN M. URIE, FINANCIAL DIRECTOR, CITY OF KANSAS CITY, MO.

Mr. URIE. Thank you, Mr. Chairman.

My name is John M. Urie, I am the director of finance of Kansas City, Mo. My testimony is given on my own behalf.

I have been involved in municipal finance for about 25 years. I have been the finance director of Tucson and Phoenix in Arizona and now of Kansas City, Mo. I do appreciate the opportunity to appear before you at this hearing.

It is my opinion that the Treasury Department has overstepped its authority in preparing its regulations and is, in fact, writing new legislation which could cause significant damage to States and their political subdivisions. I will touch on three areas of concern, although there are more than that.

First, in order to make our revenue bonds marketable and to obtain a reasonable interest cost on these bonds, we provide in our bond indentures commitments that we will create reserves which are equal to or higher than the highest year's interest and principal. Depending on the type of bonds, it may be necessary to make greater concessions. For example, toll road and toll bridge bonds require a special treatment.

The purpose of the reserve or other guarantees is to insure that in the event of shortfalls of revenues in any given year during which the bonds are outstanding, the reserves will be available as a backup so that the regular principal and interest payments can be made and the bonds will not go into default.

Normally, the reserves are created from the revenues of the enterprise, be it a water utility, a sewer utility, or an airport. Frequently, the bond indenture provides that the reserve will be used to pay the last year's principal and interest.

With regard to general obligation bonds, a reserve of this type is not required. However, good business practice in the management of the city's bonded indebtedness requires that the city maintain a reserve in its debt service fund equal to at least 1 year's principal and interest. This is not ususally a part of the bond indenture, but the rating agencies give this very careful scrutiny.

The reserve for each issue is usually created over a 4 or 5 year period from tax revenues or other revenues. The purpose of the reserve, of course is to assure that the principal and interest payments will be made each year, even though in some year there may be a shortfall of our tax revenues.

The creation of the reserves for both revenue and general obligation bonds is a valid, time-honored practice, and the Treasury Department has no defensible interest in restricting State and local governments from following this practice. By following such practices, State and local governments are able to provide additional protection for the investors, thereby improving the issuing agency's credit standing and reducing the cost of borrowing.

These situations are important because the Treasury has expressed a replacement theory to the effect that these reserves created from tax revenues or operating revenues replace the proceeds of bond sales. In other words, Treasury is saying that these reserves will be treated the same as the proceeds of a bond sale when they are invested. They use section 103(c) as the basis for this regulation.

However, if one reads section 103(c) carefully, the use of the past tense in the section conclusively establishes that the regulated money must come from the issuance of obligations and not from tax proceeds or the revenues of municipal enterprises.

I think this is where Treasury has seriously overstepped its auhority and is, in effect, writing new legislation. Another troublesome area proposed by the regulations in the section dealing with the certification process. This regulation would require certification by the issuer at the time of the delivery of the bonds on the original sale that the proceeds of the bond sale would not be used for arbitrage purposes. If the issue is more than $2.5 million, a certification by bond counsel is also required.

The extent if the increase in risk for investors through the certification process is not apparent in the regulations, but comes from the example. Treasury officials stated in example four of their illustrations that despite appropriate certification, if an artifice or device is used to produce arbitrage profits, then the bonds will not be tax exempt. This kind of interpretation by Treasury would create serious apprehension in the market. Should they ever come down on one of these, it would create utter chaos in the market.

I see that my time is about up, and while I haven't yet a moment I would like to deviate from my text and make one proposal. I am not in favor of IDB advance refunding or other kinds of advance refunding. But if we could get the regulations to let us alone with regard to our new issues, our original issues, then it would satisfy me. But so far these regulations do not do that.

I had an opportunity to take a cursory look over lunch today at new regulations that were issued last night, and they just don't do very much, in my opinion.

Thank you for allowing me to appear. I appreciate that.

Senator BENTSEN. Thank you very much, Mr. Urie. Your testimony will be helpful.

[The prepared statement of Mr. Urie follows:]

STATEMENT OF JOHN M. URIE, DIRECTOR OF FINANCE, KANSAS CITY, MO.

My name is John M. Urie. I am Director of Finance of Kansas City, Missouri. This testimony is given on my own behalf, although I know that I speak for most of the Finance Directors of larger cities throughout the United States. I have been involved in municipal finance for more than 25 years, and have been the Finance Director of three U.S. cities: Tucson, Arizona; Phoenix, Arizona; and Kansas City, Missouri.

I appreciate the opportunity to appear at this hearing and to express my concern about the proposed regulations issued by the Treasury Department relating to local government finance. These regulations would restrict the investment of taxes and revenues from our legitimate public enterprises, and I do not think this should be allowed to happen. I am also concerned about the manner in which the proposed regulations deal with the certification process, and the way in which administrative costs are treated in the regulations. It is my opinion that the Treasury Department has overstepped its authority in preparing its regulations, and is, in fact, writing new legislation which could cause significant damage to states and their political subdivisions. I will touch upon these three areas of concern in this statement.

I. In order to make our revenue bonds marketable and to obtain a reasonable interest cost on these bonds, we provide in our bond indentures commitments that we will create reserves which are equal to at least the highest year's principal and interest. Depending on the type of bonds, it may be necessary to make greater concessions or guarantees. The purpose of the reserve and other guarantees is to insure that, in the event of a shortfall of revenues in any year during which any of the bonds are outstanding, the reserve will be available as a backup so that the regular principal and interest payments can be made, and the bonds will not go into default. Normally the reserves are created from the revenues of the enterprise, be it a water utility, sewer utility or an airport. Frequently the bond indenture provides that the reserve will be used to pay the last year's principal and interest payment.

With regard to general obligation bonds, a reserve of this type normally is not required. However, good business practice in the management of the city's bonded indebtedness requires that the city maintain a reserve in its debt service fund equal to at least one year's principal and interest on general obligation bonds. This is not usually made a part of the bond indenture, but the existence of such a reserve is given careful attention by the bond rating agencies. The reserve for each bond issue is usually created over four or five years from tax revenues. The purpose of the reserve, of course, is to assure that principal and interest will be paid on the general obligation bonds if there is a shortfall of property tax revenues during any year in which any of the bonds are outstanding.

The creation of reserves for both revenue and general obligation bonds is a valid, time-honored practice, and the Treasury Department has no defensible interest in restricting state and local governments from following it. By following such practices, the state and local governments are able to provide additional protection for investors, thereby improving the issuing agency's credit standing and reducing the cost of borrowing.

These situations are important because the Treasury Department has expressed a "replacement theory" to the effect that these reserves, created from enterprise revenues or tax receipts, replace the proceeds of bond sales. In other words, the Treasury Department is saying that these reserves will be treated the same as the proceeds of bond sales when they are invested. They use Section 103(c) as the basis for this regulation. However, if one reads Section 103(c) carefully, the use of the past tense in this section conclusively establishes that the regulated moneys must come from the issuance of obligations, and not from tax proceeds or the revenues of municipal enterprises. I think the Treasury Department seriously has overstepped its authority and, is in effect, creating its own new legislation in the issuance of this regulation.

II. Another troublesome area of the proposed regulations is the section dealing with the certification process. This regulation would require certification by the issuer at the time of delivery of the bonds on the original sale that the proceeds of the bond sale will not be used for arbitrage purposes. The certification would be made by an appropirate officer of the issuer, summarily reciting facts, estimates and circumstances which qualify the obligation as a tax exempt security. However, if the issue in question is $2,500,000 or more, the certification must be accompanied by the opinion of bond counsel that the bonds are truly tax exempt.

The extent of the increase in risk for investors through the certification process is not apparent in the regulations, but comes to light in an example developed by the Treasury Department. Treasury officials state in Example 4 of their illustrations that despite appropriate certification, if an "artifice or device" is used to produce arbitrage profits, then the bond issue will not be tax exempt. This kind of interpretation by Treasury would create serious apprehension in the financial market concerning each and every bond issue. If investors are to suffer the consequences of errors, or even the intentional abuses, of a particular municipal official, they will withdraw from the market rather than run that risk. The uncertainty of possible adverse Treasury rulings will have the effect of making the entire market suffer by increasing bond prices for all state and local government issuers. Should Treasury ever actually tax investors under this example, the consequence would be immediate and unparalled turmoil throughout the muncipal security market. This cannot be allowed to occur. There is no evidence whatsoever that Congress ever intended that Treasury regulate state and local governments in such a manner.

III. The third area of proposed regulations I wish to comment on concerns the method of handling the administrative costs in the calculation of yields on bond issues and investments. Under the proposed regulations, administrative costs must be omitted from yield calculations. Without going into a detailed explanation, the impact of this regulation is to work against the best interests of state and local governments in the issuance of municipal bonds and in calculating yields for various purposes. The implication here is that the Treasury Department is issuing regulations of unbelievable complexity, and is going out of its ways to work against the best interests of state and local governments. It is difficult for me to understand the underlying reasons for such pernicious regulations.

Treasury prepared and issued the regulations without consultation with state and local governments or their professional associations. They did this in spite of the fact that we have consistently expressed a willingness to meet with Treasury officials and discuss the development of these and other regulations. We made very little progress at hearings held by Treasury Department officials three weeks ago where we made a last desperate appeal for Treasury to postpone the implementation of the regulations beyond September 1.

Thus, Treasury, through its unwillingness to meet and discuss the development of regulations, and its adamant position with regard to the September 1 implementation, leaves us no choice but to support S-3370. We believe that the arbitrary and capricious actions of Treasury officials, and their possible ultra vires acts must be brought under control, and the Bentsen Bill will do exactly that.

Senator BENTSEN. I think the afternoon has been productive for us. We have heard some new viewpoints, I think, from the Secretary. In turn, we have heard from some very well-informed witnesses as to the actual results that we have seen in some of our financing for municipalities.

One of our problems here is that we can write 1 page of law and we get 50 pages of regulations, and often they do not carry out the original intent of the law. That is not peculiar to Treasury, either.

Someone else said that it appeared that the Treasury had painted with a broad brush, and I said that was not unique to them. I should have also included the Congress on that one. We have been guilty of that from time to time.

I am very appreciative of the fact that many of you gentlemen have traveled far to come here and tell us of your concerns. They have been very helpful to us.

We have so many competing committees going on at this time, plus the action on the floor, that we have not had the full attendance I would like. This does not mean that this isn't of profound interest to all of our membership.

We had full hearings all morning on the tax bill and we have been having them every morning and on some afternoons, too.

With that, we will close these hearings. Thank you all very much.

[Whereupon, at 3:50 o'clock, p.m., the committee adjourned, to reconvene on Friday, August 25, 1978.]

APPENDIX

MATERIAL SUBMITTED BY MURRAY L. WEIDENBAUM

PUBLICATION NUMBER 21 SEPTEMBER 1978.

The Case for Tax Loopholes

Murray L. Weidenbaum

Presenting the case in favor of tax loopholes may seem to be an example of trying to defend the indefensible. *Loophole*, of course, is a perjorative term indicating some special advantage that a person or group has achieved, presumably at the expense of the public welfare. And, as we are told repeatedly, eliminating all of the loopholes would permit a massive reduction in tax rates without any overall decline in revenues.

The implicit trade-off sounds so desirable that we may wonder why the change has not been made before. An obvious answer of course quickly comes to mind: the special interests have prevented it. Although that may be the popular answer, a quite different one will be presented here, one which is based on a broader view of public policy. We will examine the role of these special tax provisions in the light of the totality of governmental tax, expenditure, and regulatory activities, especially as these affect the relationship of public to private activities in the United States.* But before doing so, we will cover some preliminary material. It will be helpful to examine the nature of the various loophole arrangements and their impacts on the tax system of which they have become so basic a part.

Technically, the term *loophole*—at least in my understanding—applies to that broad and disparate range of specific provisions in the tax code which permits one or more taxpayers to depart from the general structure used for taxing income. To clear the air at the outset, I am not about to defend every

* The author is indebted to Robert DeFina for the calculations of tax expenditures by income class and for other helpful assistance. Numerous useful comments on an earlier draft were made by Linda Rockwood.

"raid" on the Treasury. That is, I will not be supporting the desirability of each and every special provision of the Internal Revenue Code. As a general proposition, I do favor the economic notion of "horizontal equity"—that is, equal treatment of taxpayers in similar circumstances. And it should be recognized that a "cleaner" tax code—one with fewer special provisions—likely would help to achieve a greater degree of horizontal equity.

Yet, it needs to be acknowledged that there is room for a good degree of legitimate quibbling as to who are the equals to be treated equally. The taxpayer who devotes a portion of his or her income to voluntary contributions to eleemosynary institutions may quite properly be viewed a bit differently than the taxpayer with identical income who devotes all of that income to his or her personal gratifications. This would seem to be one of the many instances in life where sensible results are more likely to be achieved by carefully balancing a variety of important considerations, rather than single-mindedly attempting to pursue just one.

In this brief examination of the composition of tax loopholes I will, of course, try to avoid the obvious distinction that those special tax provisions which benefit me are essential to the public welfare, but those that benefit you are just low priority giveaways. As Professor Boris Bittker explained on this campus on an earlier occasion, there are very few tax provisions which meet the formal dictionary definition of loophole, that is, "an ambiguity or omission in a statute, etc., which affords opportunity for evading its intention."[1] In the main, tax loopholes are not the product of an ingenious attorney or accountant laboriously examining the minutia of the Internal Revenue Code. Rather, the typical loophole was deliberately placed there by the Congress to achieve a public purpose, a purpose of which you or I may speak good or ill. Even as enthusiastic a critic of these special tax provisions as Professor Stanley Surrey has been moved to note that many of them "were expressly adopted to induce actions which the Congress considered in the national interest."[2]

To belabor the obvious, the charitable deduction was not inserted in the tax system to provide windfall gains to the wealthy but, in Professor Surrey's words, "to foster philanthropy." As we are about to see, however, the providers of that philanthropy constitute a varied lot.

THE NATURE AND COMPOSITION OF TAX EXPENDITURES

As it turns out, there is a classification of special tax provisions which is available for our use. In recent years, the term *tax expenditures* has been applied to those features of the tax law which have often been labeled as loopholes. A formal definition is more descriptive, albeit somewhat formidable: revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Before turning to the data, however, a critique of the tax expenditure concept is in order. On its surface, that dreadful phrase may seem to be an anomaly: either something is a tax or it is an expenditure. According to Professor Surrey, who is generally acknowledged to be the father of the tax expenditure concept, "The term 'tax expenditure' has been used to describe those special provisions of the federal tax system which represent government expenditures made through that system to achieve various social and economic objectives."[3] The notion that the tax incentive device involves the expenditure of government funds is, in my opinion, a fundamental error, however, and one that leads to all sorts of erroneous public policy.

The Surrey view seems to be based on the implicit assumption that the state is entitled to as much of the taxpayers' income as it desires. Hence, the citizen's claim on his or her own income is secondary or residual. Thus, any reduction in that flow of private income to the public Treasury is viewed as an act of grace by a benevolent sovereign. To the contrary, a tax expenditure—if the concept is to have any justification—signifies less taking of private funds by government. This is a simple but powerful point. In my view, tax expenditures should be seen in the context of the substantial taxes which are being paid by private individuals and corporations. To tell a person who is paying out over a third of his or her income in federal taxes that he or she is unduly benefiting from some tax expenditure reflects a strange view of tax equity. And to be told that by a beneficiary of the low income allowance compounds the insult.

Tax expenditures or tax incentives are designed to alter private behavior in an economy already strongly influenced by government; they are intended specifically to increase private expenditure on a particular item or category. From a purely fiscal viewpoint, a dollar less paid in taxes has the same effect on the budget position as a dollar more disbursed by government. But, a variety of different consequences may flow from choosing the tax or the expenditure route for achieving public purposes.

An important shortcoming of the tax expenditure concept arises from the method used in estimating the dollar magnitudes. The data reported do not take any of the indirect effects from the operation of each of these special tax provisions into account.[4] Many of the tax expenditures alter taxpayer behavior and economic conditions. In many cases that is their purpose. Their elimination also might require offsetting changes in federal expenditure programs or in other aspects of the tax system in order to avoid obviously undesirable effects—but thus preventing the Treasury from recapturing the full revenue loss. The tax exemption of interest received on state and local bonds is an interesting case in point. On the surface, this provision appears merely to provide tax relief to the high bracket holders of these securities. And numerous tax reformers urge the prompt elimination of this "loophole" on that basis. But, on reflection, the tax exemption enables the states and localities to issue bonds at lower interest rates than other borrowers of comparable risk categories. (Certainly, the purchasers of these securities would turn to higher yield issues if the interest were to become taxable.)

Thus, some of the tax expenditure also implicitly involves a substantial subsidy to the governmental units issuing these securities. In fact, the more sophisticated tax reform proposals designed to eliminate or reduce the use of the tax-exempt securities do provide for the payment of federal subsidies to state and local governments to offset the higher interest payments that they would have to make in order to sell their securities in the "taxable market." Depending on the subsidy level, there could be a net loss or a net gain to the Treasury from the combination of closing the tax-exemption loophole and simultaneously subsidizing state and local governments to enable them to continue selling bonds at low interest costs.[5]

Despite these and other shortcomings, the available data on tax expenditures are useful in making some rough approximations of the distribution of the beneficiaries of tax loopholes. The results may well come as a surprise to many of the enthusiastic but less critical supporters of the concept.

Some of the "tax expenditures" are well known and have become notorious. A few ready examples are depletion allowances, the tax exemption of the interest on state and local bonds, and those provisions which have been used to shelter certain types of real estate income (such as expensing of interest and taxes paid during the construction of buildings). However, it may come as a surprise to many that these items comprise a relatively small portion of the $95 billion of tax expenditures—losses in revenue—reported by the Treasury Department in the fiscal year 1976.[6] The great bulk of the $95 billion, rather, consists of items which I suspect the vast majority of the public never thinks of as a loophole.

Among the largest tax expenditures, for example, are the deductibility of mortgage interest and property taxes on owner-occupied residences. The tax treatment of these two items of personal expense of the typical homeowner accounts for a total of $8.9 billion of revenue foregone in the fiscal year 1976. Other significant special provisions include deducting charitable contributions ($5.4 billion revenue loss to the Treasury), personal, state, and local taxes, other than on homes ($8.0 billion) and excluding from taxation employer and self-employed contributions to employee pensions ($8.4 billion), medical insurance premiums and medical care programs for employees ($4.5 billion), as well as social security and unemployment benefits ($7.0 billion).

However, merely reciting specific examples such as these may give a distorted picture of the total reality. Tables 2.1 and 2.2, therefore, are an attempt to show the overall distribution of tax expenditures by income class. The data on tax expenditures are taken from the official tabulation in the annual federal budget. The assignment of tax expenditure benefit to income classes is based on a Treasury Department study of 1971 data prepared for the Joint Economic Committee.[7] I have divided the data into three categories—benefits to the lower-income groups, to middle-income groups, and to upper-income groups.

The amounts shown in the category "lower-income groups" are based on the proportion of each tax expenditure in 1971 received by those taxpayers with adjusted gross income of $10,000 or less. The data for the "middle-income groups" are based on the proportion of each tax expenditure in the base year going to taxpayers with adjusted gross income of $10,000 to $50,000. Frankly, I would have preferred using a lower top limit for the middle grouping, but the Treasury did not split up the category, $20,000 to $50,000. Nevertheless, the bulk of the tax expenditures (56 percent in 1971) was received by the bottom half of the middle group—those reporting adjusted gross incomes of $10,000 to $20,000. The "upper-income groups" in these tables consist of taxpayers with adjusted gross incomes of $50,000 and over. I have made no attempt to trace through the incidence of the tax expenditures received by corporations, although I would expect that a substantial portion of the ultimate benefit is received by lower-income and middle-income groups.

The public finance literature provides a variety of viewpoints. Personally, I subscribe to a mixed case, in which some of the benefits are shifted forward to consumers in the form of lower prices, some are shifted backward to employees in the form of higher incomes and fringe benefits, and some significant amount benefits the shareholders. Examples of probable backward shifting, although relatively small, may be the most apparent. I have in mind here the tax credit for employing welfare recipients and the increase in the investment credit for the companies that use the proceeds to finance employee stock ownership plans.

Table 2.1

SUMMARY OF TAX EXPENDITURES, FISCAL YEAR 1976
(in billions of dollars)

	Amount	Percent of Total
Estimated benefits to lower income groups	$17.9	19
Estimated benefits to middle income groups	38.6	40
Estimated benefits to upper income groups	15.9	17
Estimated benefits to corporations	22.9	24
Total	95.3	100

Source: Summary of details shown in Table 2.2

As shown in Table 2.1, the bulk of all the estimated tax expenditures are received by lower- and middle-income taxpayers—$56.5 billion out of $95.3 billion in 1976, or 59 percent of the total. By and large, the major recipients of the tax expenditure benefits received by personal (as contrasted to corporate) taxpayers are those in the middle-class category—$38.6 billion compared to $17.9 billion for the lower-income category and $15.9 billion for the upper-income category.

Several large tax expenditures benefit primarily lower-income taxpayers. Among these are the tax exemption of various government transfer or benefit payments which are received primarily by low-income people who would otherwise have to pay taxes on such income, e.g., veteran's disability compensation payments ($595 million of revenue foregone), social security benefits ($2.7 billion), and unemployment benefits ($3.3 billion).

To be sure, several important types of tax expenditures tend to benefit primarily corporations and investors and other relatively high-bracket income earners. Examples in this category include the special tax treatment of capital gains ($7.9 billion), the investment credit ($9.5 billion), the exclusion of interest on state and local debt ($4.8 billion), and the excess of percentage over cost depletion ($1.3 billion). Clearly, the $95.3 billion of tax expenditures in the fiscal year 1976 cannot be characterized as merely an array of depletion allowances and other very specialized or esoteric tax provisions.

Table 2.2 shows the great variety of the specific tax expenditures for which the Treasury Department publishes estimated dollar magnitudes. A detailed analysis of the derivation of the income class distributions is contained in the statistical appendix.

Table 2.2

ESTIMATED TAX EXPENDITURES, FISCAL YEAR 1976
(in millions of dollars)

Item of Tax Expenditure	*Benefit To Income Group*				
	Lower Income	*Middle Income*	*Upper Income*	*Corpo-rations*	*Total*
Benefit Primarily to Lower-Income Group					
Exclusion of benefits and allowances to armed forces personnel	765	245	10	—	1,020
Disability insurance benefits	277	46	7	—	330
Exclusion of social security benefits	2,153	491	81	—	2,725
Additional exemption for the blind	14	6	—	—	20
Exclusion of sick pay	101	90	4	—	195
Exclusion of unemployment benefits	1,968	1,334	33	—	3,335
Exclusion of public assistance benefits	95	—	—	—	95
Deduction and credit for child and dependent care expenses	241	49	—	—	290
Exclusion of scholarships and fellowships	144	51	—	—	195
Exclusion of veteran's disability compensation	309	280	6	—	595
Excess of percent standard deduction over low-income allowance	855	274	11	—	1,140
Earned income credit	165	53	2	—	220
Subtotal	7,087	2,919	154	—	10,160
Benefit Primarily to Middle-Income Group					
Exclusion of military disability pensions	22	48	20	—	90
Exclusion of veterans' pensions	7	16	7	—	30
Exclusion of G.I. Bill benefits	73	162	70	—	305
Additional exemption for over 65	275	607	263	—	1,145
Retirement income credit and credit for the elderly	26	58	26	—	110
Exclusion of capital gain on home if over 65	10	21	9	—	40
Exclusion of railroad retirement system benefits	46	101	43	—	190

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Table 2.2 continued

Benefits for dependents and survivors	155	342	148	—	645
Exclusion of special benefits for disabled coal miners	12	27	11	—	50
Exclusion of income earned abroad by U.S. citizens	32	110	3	—	145
Expensing of certain capital outlays by farmers	159	241	55	85	540
Capital gains treatment of certain income of farmers	110	167	38	10	325
Dividend exclusion	90	288	52	—	430
Deduction of interest on consumer credit	316	1,684	105	—	2,105
Deduction of mortgage interest on residences	779	3,799	292	—	4,870
Deduction of property taxes on residences	564	2,902	564	—	4,030
Depreciation on rental housing in excess of straight line	49	194	162	100	505
Housing rehabilitation	3	15	7	15	40
Exclusion of workers' compensation benefits	283	295	12	—	590
Exclusion of pension contributions and earnings	1,980	5,383	987	—	8,350
Exclusion of employer-paid premiums on accident and life insurance	217	556	57	—	830
Exclusion of employer-paid medical insurance premiums and medical care	1,212	3,008	270	—	4,490
Exclusion of employer provided meals and lodging	133	164	13	—	310
Exclusion of income of trusts to finance supplementary unemployment benefits	4	6	—	—	10
Exclusion of interest on life insurance savings	215	1,225	215	—	1,655
Deduction of charitable contributions	531	2,496	1,843	540	5,410
Deduction of medical expenses	764	1,389	162	—	2,315
Deduction of casualty losses	84	167	59	—	310
Parental personal exemptions for students, age 19 and over	209	418	93	—	720
Deduction of nonbusiness state and local taxes	823	4,584	2,558	—	7,965
Credit and deduction for political contributions	8	19	8	—	35
Deferral of capital gain on home sale	135	659	51	—	845

Table 2.2 continued

Credit for purchase of new home	104	507	39	—	650
Deferral of interest on savings bonds	132	292	126	—	550
Excess first-year depreciation	29	94	17	40	180
Maximum tax on earned income	145	321	139	—	605
Subtotal	9,736	32,365	8,524	790	51,415
Benefit Primarily to Upper Income Group					
Capital gains	439	1,830	5,051	545	7,865
Capital gains treatment of royalties on coal and iron ore	2	10	28	15	55
Subtotal	441	1,840	5,079	560	7,920
Benefit Primarily to Corporations					
Investment credit	507	923	380	7,685	9,495
Credit for employing AFDC and public assistance recipients	—	—	—	10	10
Depreciation on buildings (other than housing) in excess of straight line	24	96	80	225	425
Employee stock ownership plans financed through investment credit	—	—	—	25	25
Exemption of credit unions	—	—	—	145	145
Exclusion of certain income of cooperatives	-33	-104	-18	410	255
Corporate surtax exemption	—	—	—	4,170	4,170
Capital gains treatment of certain timber income	11	28	56	290	385
Expensing of exploration and development costs	14	59	87	640	800
Excess of percentage over cost depletion	23	105	157	1,010	1,295
Exclusion of interest on state and local debt	17	263	1,365	3,115	4,760
Expensing of research and development	5	17	3	1,325	1,350
Expensing of construction period interest and taxes	52	114	49	415	630
Exclusion of gross-up on dividends of LDC corporations	—	—	—	40	40
Deferral of income of Domestic International Sales Corporations	—	—	—	1,220	1,220
Special tax rate for western hemisphere trade corporations	—	—	—	50	50
Deferral of tax on shipping companies	—	—	—	110	110

Table 2.2 continued

Railroad rolling stock five-year amortization	–	–	–	25	25
Excess bad debt reserve of financial institutions	–	–	–	485	485
Credit for corporations in U.S. possessions	–	–	–	240	240
Subtotal	620	1,501	2,159	21,585	25,865
Total	17,884	38,625	15,916	22,935	95,360

Source: Data in total column and for corporations taken from *Special Analyses, Budget of the United States Government, Fiscal Year 1978.*

JUSTIFICATIONS FOR TAX INCENTIVES

Many justifications have been put forward for the various special tax provisions. Typical national objectives cited by the proponents have ranged from fostering employment and economic growth, to enhancing equity, to supporting worthy private institutions and state and local governments. The specific weight given to any of these objectives is, of course, a rather subjective matter.

The special treatment of the major tax expenditures received by upper-income taxpayers and corporations—capital gains, the investment credit, and similar items—is justified by the need to promote investment and hence achieve a growing economy, which will provide both more employment and a rising standard of living for the public as a whole. We need to recall also that the special tax treatment of capital gains was instituted prior to the insertion of the income-averaging concept into the Internal Revenue Code. In that earlier period, were capital gains to have been taxed at ordinary income rates, many taxpayers would have been paying taxes on long-term gains far higher than the brackets that would correspond to their income levels during the period in which those gains were accruing (that is the "bunching" phenomenon). Now that income averaging has been extended to capital gains, the primary justification for differential treatment must be viewed in other terms—providing desired inducements to investment. We should be aware of the obvious: to the extent that the private sector is unable to raise the funds to finance economic growth, pressure rises for greater governmental involvement in business affairs.

Surely in recent years the federal government has become an important competitor for investment funds. The Treasury's financing of budget deficits plus a growing array of federally owned or federally sponsored credit agencies have obtained one-third or more of the total funds flowing through the nation's capital markets.[8] Viewed from this prospective, the various tax expenditures devoted to encouraging private investment may merely offset the deleterious effects of the government's own expenditure and borrowing activities.

Turning to another major tax expenditure, the deductibility of state and local taxes furthers the objective of strengthening the other levels of government through the federal government's sharing the burden of the taxes levied by these jurisdictions. This can be viewed as an early "revenue sharing" effort. Moreover—in the absence of this deduction or a provision with similar effect—the combination of federal, state, and local income taxes for some taxpayers could result in a total rate close to 100 percent of income, thus bordering on sheer confiscation. When the top bracket of the federal income tax was 93 percent, this was a very real possibility.

Numerous reasons are cited for the tax deductibility of charitable contributions. The voluntary, private institutions thus supported provide diversity and free choice. They can experiment and enter fields too controversial for government agencies. They often take on responsibilities which otherwise would be financed entirely by tax revenues.[9] .

The deductibility of interest paid by individuals (that is, interest on personal as opposed to business indebtedness) is a more complicated matter. The largest portion is interest on mortgages on owner-occupied homes. The deterioration of many central cities in recent years has strengthened the justification of enhancing family and neighborhood stability by encouraging individual home ownership. The deductibility of interest on general consumer debt may be more difficult to defend. Personally, I find it hard to see why the general taxpayer should subsidize the families that wish to go into debt to buy new refrigerators or second cars. In contrast, the interest that individuals receive on their savings is, of course, fully taxable. Perhaps, although unintentionally, this provision also illustrates the tendency of the tax system to tilt in favor of consumption rather than saving.

Some personal deductions are really reasonable refinements of gross income in order to obtain a fair and equitable concept of a taxable income base. Cases in point are the deductions of expenses related to earning income, such as union dues, child care for working wives, work clothing, and fees on safe deposit boxes for securities. A few corporate tax exemptions—notably the exemption of credit unions and some of the income of cooperatives—are an aid to those nonprofit institutions organized in the corporate form.

As in each of the other cases cited here, I am making no attempt to assess the adequacy of these justifications, but merely to emphasize that there is another side to the traditional tax reform arguments. Although most popular discussions of tax reform tend to ignore the substantive purposes of many of these special tax provisions, the underlying literature of public finance does not. In the most definitive study of personal tax deductions, for example, Professor C. Harry Kahn states that these tax provisions are designed to "differentiate between taxpayers whose incomes, though apparently equal, are of different sizes in some relevant sense."[10]

Thus, without prejudging their effectiveness, we should note that at least some special tax provisions (perhaps the additional exemption for the blind or the deduction of casualty losses) are intended to further the achievement of horizontal equity—equal treatment of equals. Professor Kahn goes on to state that "care must be taken not to designate the tax equivalents [the revenue foregone from personal deductions] as simple tax losses. If intended to spur private expenditures, for instance, in the philanthropic domain, the figures represent more accurately the tax cost to the government of encouraging expenditures which might otherwise have to be undertaken by government."[11]

SHORTCOMINGS OF THE TAX INCENTIVE APPROACH

Surely the Internal Revenue Code contains numerous "marginal" subsidies, in which modest tax benefits enable the private sector to continue some worthy undertakings (hospitals or orphanages, for example) at a fraction of the cost which the federal Treasury would have to bear should the activities be run by the state. But there also are tax "shelters" in the Code which provide an inordinate amount of benefit to the recipients or cost to the Treasury, far out of proportion to their value to society as a whole.

Special tax provisions (tax expenditures) have been criticized on numerous grounds. Many of them, especially the deductions from income, are attacked as being regressive, because they reduce the tax burdens of upper-income taxpayers more than those of lower-income taxpayers. Deductions clearly do have that effect. Under the deduction approach, the amount of tax saving per dollar of deductible expenditure depends on the marginal tax bracket of the taxpayer. Thus, an upper-income taxpayer receives a larger tax reduction than does a lower-income taxpayer for making the same dollar amount of charitable contribution or payment of state and local taxes.

In effect, the government subsidizes the taxpayer to the extent of 14 percent of the state and local taxes and charitable contributions for the individual or family in the lowest tax bracket—when they itemize rather than take the standard deduction. In the case of those in the top bracket, the government subsidizes 70 percent of those expenditures, and somewhere in between for the others. The many taxpayers using the standard deductions receive no tax benefits from their contributions.[12]

From the viewpoint of achieving desired public policy objectives, special tax provisions lack some of the compelling characteristics of direct expenditures. Typical—but not all—direct expenditure programs offer the following advantages: the public has a clearer picture of the flow of federal assistance; the Congress can exercise annual control over the size and distribution of the benefits; the financial aid given to private individuals and groups can be weighed against the desirability of government agencies taking direct responsibility for the programs in question. This idyllic view, however, is not readily reconcilable with the reality of trends in the federal budget. In recent years, the relatively "uncontrollable" expenditure programs—social security pensions, interest on the public debt, unemployment compensation, et cetera—have come to dominate total federal spending. In fact, many of these programs do not even appear in the annual appropriation bills but are funded via so-called permanent and indefinite appropriations.[13]

PROSPECTS FOR CHANGE

As pointed out earlier in this paper, this is not a plea for the retention of every special provision in the tax system. To an economist, it is reasonable to contrast the costs and benefits of various mechanisms for achieving public policy objectives. It certainly is conceivable that, in some cases, direct expenditures may be a more desirable alternative than tax incentives. In other cases, credit assistance or regulatory programs or still other approaches may be preferred, such as just letting the market work. There seems to be little need to take a doctrinaire attitude and prohibit public policy from using any one of these alternatives. Rather, the advantages and disadvantages of each mechanism should be weighed, and the most desirable one used to achieve a specific objective, be it the encouragement of business investment or the discouragement of environmental pollution.

However, the implications of moving from indirect support through the tax system to direct federal expenditure subsidies are profound, especially in the many instances of aid to private, state, and local institutions. Taken erally (as has been suggested by some tax reformers), this move would mean putting private hospitals, orphanages, schools, and similar social service and charitable institutions into the federal budget.[14] The opportunities for federal influence and control over the conduct of these private organizations would be obvious and could be very considerable.

Moreover, the constitutional separation of church and state would probably prevent extending such direct general purpose financial support to church-related medical and educational facilities and certainly to the religious institutions themselves. The choice between tax incentives and direct federal expenditures turns out to involve more than the selection among technical financing mechanisms. The choice involves altering the balance between public and private power in our society. The issue is seldom clearly joined, which may explain why the debate gets so heated at times.

However, the use of the tax incentive route does not require adhering to the specific types of tax mechanisms now in use. For example, the deduction from taxable income is not the only way in which the tax system can be used to encourage taxpayers to spend some of their money in a manner which accords with national interests. It is merely an example of the power of the status quo. Deductions have been part of the system since the institution of the income tax law in 1913.

An alternative to the deduction is already available and has been used in various specific instances: the tax credit, which is a deduction from the ultimate tax liability rather than from taxable income. Although the distinction between credits and deductions may be considered to be a technical matter only of interest to specialists, the differences in effects may be very significant for the individual taxpayer. Given the progressive nature of the personal income tax structure, ordinary deductions are implicitly regressive. Credits can be more flexible. A credit can be given in terms of a percentage of an expenditure, and various ceilings may be put on the amount of the credit. Moreover, credits can be extended to that vast portion of low and moderate income taxpayers that do not itemize individual contributions, but use the standard deduction.

The credit concept is in widespread use in the corporate tax structure, where its use ranges from encouraging the employment of welfare recipients to expanding business plant and equipment. In the individual tax system, credits are now provided for child and dependent care expenses, retirement income, and political contributions—sometimes as a voluntary alternative to the deductions. Suggestions to use tax credits in place of personal exemptions—$750 is the present deduction for each taxpayer and dependent—have been made by President Carter and Vice-President Mondale, among others.

As pointed out earlier, the value of a deductible dollar varies with the taxpayer's bracket. With a fixed percentage credit, in contrast, a given dollar of charitable outlay, for example, would generate the same amount of tax saving, regardless of the taxpayer's income level. Of course, the upper-bracket taxpayers might make a larger donation and thus qualify for a larger absolute tax benefit, but they would receive the same proportional benefit. Depending on the percentage allowed as the credit, such a system could reinforce the progressivity of the personal income tax, since those taxpayers whose marginal rates were below the percentage credit would have their average bill reduced. Those in the higher brackets would find their tax bills raised if credits were substituted for deductions.

The mechanism of a tax credit could be important in strengthening the role of voluntary organizations in our national life by making them more democratic. Because the proposed tax credit would operate to the advantage of lower- and moderate-income taxpayers, it could help to create a potential new constituency for private institutions, freeing many of them from their present dependence on the wealthy few. Unlike the alternative of direct support through government expenditures, substituting tax credits for personal deductions would constitute a modest step toward decentralizing decision-making in our society and encouraging diversity in the way that social objectives are achieved.

One would wish to cite a less shopworn metaphor, but the typical tax reformer tends to concentrate on the hole rather than on the doughnut. Unfortunately, the existing situation seems to be a fine example of the Lord (or the Feds, rather) giveth and the Feds taketh away. Private institutions in the United States, of course, were alive, well, and growing prior to their support through the income tax system. No doubt the powerful combination of heavy taxation and the expansion of public philanthropy and functions has adversely affected both the ability and the incentive of private citizens to support private undertakings and has led to the need for offsetting aid via the tax incentive route.

As has been amply demonstrated in another connection, a major long-term barrier to private sector saving and investment is the large governmental budget deficits whose financing is competitive with private undertakings. If the public sector were smaller and its intrusion into the private sector substantially reduced, there might be little need to advocate supporting private institutions via the tax system. To be sure, some private interests—be they business, labor, agriculture, or any other—will always try to enrich themselves at the expense of the public welfare. But that knowledge should not cause us to overlook the fundamentally adverse impacts of government action on the private sector.

Perhaps we have come full circle. The aims of the conventional tax reformers and the objectives of the apparent defenders of the status quo may not be as far apart as they initially appear to be. The reconciliation of the two sets of objectives may lie in the more widespread understanding of the conditions that led to the adoption of so many of the special tax provisions in the first place. The simple elimination of these tax provisions often would leave unfulfilled the objectives that they are designed to foster. Yet a more effective approach to public policy might be in dealing with the basic conditions that often prevent private institutions—business and nonprofit alike—from performing their intended functions, conditions that frequently—and on occasion unwittingly—result from the rapid expansion of governmental activities. Dealing with those basic conditions would have the added advantage of avoiding the revenue losses and the equity problems that may result from using tax incentives.

One example, among many, may help to particularize this general notion. As many studies have demonstrated, the compulsory minimum wage law tends to price low-skilled and less-educated workers, especially teenagers, out of the labor market. To some extent, this adverse effect is offset by tax credits which are intended to encourage employers to give jobs to this target population. I am confident that if *both* programs were eliminated simultaneously, employment would rise, the budget deficit would be reduced, and the general welfare would be enhanced. But to eliminate the tax expenditure while ignoring the underlying problem, as seems to be the traditional approach to tax reform, would be another exercise in futility.

Similarly, the need for tax incentives to encourage private support of educational institutions arises in large part from the adverse effects of other governmental actions. The rapid expansion of classrooms and educational buildings in public institutions has frequently resulted in much of the higher educational system operating far below capacity and thus pushing up unit costs. (More generous scholarships directly paid to students would have been a far more efficient approach.) These upward cost pressures are in addition to the basic inflation engendered by federal fiscal and monetary policy.

A similar situation arises in the health field. The overly rapid expansion of hospitals has resulted in empty beds with attendant upward pressures on unit costs. And, further, the inflation in health care costs resulting from the government's medicare and medicaid programs has exacerbated the financial squeeze facing private health care institutions.

It is cavalier, to say the least, for the naive tax reformers to blithely ignore all of the adverse impacts of government action on private institutions and then pick on one of the few areas of public policy—tax expenditures—where the public sector attempts to undo the damage.

CONCLUSIONS

In this paper I have attempted to show that a sympathetic examination of "loopholes" or tax expenditures, to use the more technical and quantifiable term, can be useful. The mechanism of tax expenditures or incentives may serve a variety of public purposes, ranging from promoting business investment and economic growth to encouraging private, voluntary organizations.

Indeed, the growth of tax expenditures may be viewed as a reaction to the severe impacts that the expansion of government power and activities has had on the viability of private sector institutions. But the prompt elimination of those obstacles, such as large deficit financing and pervasive government regulation, seems to be an unrealistic expectation. Hence, the reliance on second-best alternatives, such as tax expenditures, may on occasion be a sensible route.

The survey of the specific tax expenditures undertaken here reveals that, in the main, they are not special benefits to the highest-income classes nor the product of ingenious accountants or attorneys. Rather, the typical tax expenditure benefits primarily middle- and lower-income groups of the population. Nor are the major tax expenditures obtained by engaging in unusual activities. Rather, they are received from such prosaic activities as paying state and local taxes, owning a home, and working for a company that provides group insurance and other fringe benefits.

To be sure, not all tax expenditures are of this nature—and not each one needs to be defended. But the point being made here is that neither should the entire category be condemned and its elimination urged as an unequivocal matter of equity.

As pointed out in this paper, there are reforms which could be instituted—such as more widespread use of the tax credit device—to simultaneously help to achieve greater progressivity in the tax structure and still serve to attain the basic purposes intended by the Congress.

Given the current interest in tax reform, it seems evident that proposed changes should be viewed in a broader context than in the past. Questions of income distribution and macroeconomic policy have tended to dominate the discussion of tax reform. But we must also address such other important aspects as the effects on the respective roles of the public and private sectors and of federal, state, and local governments and the resultant shifts in the distribution of power in the society.

All in all, tax incentives may, in this imperfect world, often be the most realistic available alternative to achieving such important objectives as enhancing economic growth and employment, strengthening state and local governments, and encouraging a diversity of private, voluntary approaches to meeting society's needs.

NOTES

1. Boris I. Bittker, "Income Tax 'Loopholes' And Political Rhetoric," *Michigan Law Review*, May 1973, p. 1102.
2. Stanley S. Surrey, "Tax Incentives as a Device for Implementing Government Policy," *Harvard Law Review*, February 1970, p. 711.
3. *Ibid.*, p. 706.
4. See Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), appendix to chapter 1.
5. See David J. Ott and Attiat F. Ott, "The Tax Subsidy Through Exemption of State and Local Bond Interest," in U.S. Congress, Joint Economic Committee, *Economics of Federal Subsidy Programs*, Part 3, (Washington: Government Printing Office, 1972); Frank E. Morris, "Tax Exemption for State and Local Bonds," *George Washington Law Review*, March 1974, pp. 526-36.
6. "Tax Expenditures," *Special Analyses, Budget of the United States Government, Fiscal Year 1978*, (Washington: Government Printing Office, 1977), pp. 119-42.
7. Statement of Edwin S. Cohen, Under Secretary of the Treasury, before the Joint Economic Committee, July 21, 1972.
8. Murray L. Weidenbaum, *Business, Government, and the Public* (Englewood Cliffs: Prentice-Hall, 1977), p. 138.
9. See *Giving in America*, Report of the Commission on Private Philanthropy and Public Needs, 1975.
10. C. Harry Kahn, *Personal Deductions in the Federal Income Tax* (Princeton: Princeton University Press, 1960), p. 174.
11. *Ibid.*, p. 178.

[12] See Murray L. Weidenbaum, "The Advantages of Credits on the Personal Income Tax," *George Washington Law Review*, March 1974, pp. 516-25.

[13] Murray L. Weidenbaum, "Institutional Obstacles to Reallocating Government Expenditures," in *Public Expenditures and Policy Analysis*, ed. Robert Haveman and Julius Margolis (Chicago: Markham Publishing Co., 1970), pp. 232-45.

[14] Paul R. McDaniel, "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deductions," *Tax Law Review*, 1972, pp. 409-11.

TABLE II-4

Taxes and Transfers as a Percentage of Income: 1965

Income class	Taxes: Federal	Taxes: State and local	Taxes: Total	Transfer payments	Taxes less transfers
Under $2,000	19%	25%	44%	126%	−83%*
$2,000-$4,000	16	11	27	11	16
$4,000-$6,000	17	10	27	5	21
$6,000-$8,000	17	9	26	3	23
$8,000-$10,000	18	9	27	2	25
$10,000-$15,000	19	9	27	2	25
$15,000 and over	32	7	38	1	37
Total	22	9	31	14	24

*The minus sign indicates that families and individuals in this class received more from federal, state, and local governments than they, as a group, paid to these governments in taxes.

Joseph A. Pechman, "The Rich, the Poor and the Taxes They Pay," *The Public Interest*, November 1969. The data are from the *Economic Report of the President*, 1969, p. 161.

Source: Herman P. Miller, Rich Man, Poor Man, published by Thomas Y. Crowell Co., New York, 1971, page 17.

BIOGRAPHICAL SKETCH

Murray L. Weidenbaum is Director of the Center for the Study of American Business at Washington University in St. Louis, Missouri. He is the author of a new book, Business, Government, and the Public, published by Prentice-Hall in 1977.

He has held a variety of business and government positions. During 1969-71, Dr. Weidenbaum served as Assistant Secretary of the Treasury for Economic Policy. He joined the Washington University faculty in 1964 and was chairman of the Economics Department from 1966 to 1969. He has held the Mallinckrodt Distinguished University Professorship since 1971. From 1949 to 1957 he was a Fiscal Economist in the U.S. Bureau of the Budget and from 1958 to 1963, he was the Corporate Economist at the Boeing Company. He is the consulting economist to the First National Bank in St. Louis and to Mallinckrodt, Inc.

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Dr. Weidenbaum is a 1948 graduate of the City College of New York. He received an MA from Columbia University in 1949 and his PhD in economics from Princeton University in 1958. He was awarded the Townsend Harris Medal by the City College Alumni Association for "distinguished achievement" and the Distinguished Writers Award by the Center for Strategic and International Studies. He is also a recipient of the Alexander Hamilton Medal "in recognition of distinguished leadership in the Department of the Treasury."

He is a Fellow of the National Association of Business Economists, and served on the original Board of Directors of the National Economists Club. He is a member of the Council on Foreign Relations. Mr. and Mrs. Weidenbaum, and their three children (Susan, James, and Laurie), make their home in Creve Coeur, Missouri.

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