TAX INCENTIVES FOR EXPORTS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 231, S. 700, S. 935, S. 1003, S. 1065

JUNE 18, 1979

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TAX INCENTIVES FOR EXPORTS

MONDAY, JUNE 18, 1979

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Long, Bentsen, Bradley, Packwood, Wallop, and Danforth.

[The press release announcing this hearing and the bills S. 231, S. 700, S. 935, S. 1003, and S. 1065 follow:]

PRESS RELEASE

For Immediate Release—May 17, 1979

U.S. SENATE, COMMITTEE ON FINANCE

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARINGS ON TAX INCENTIVES FOR EXPORTS

Subcommittee Chairman Harry F. Byrd, Jr. (I., Va.) today announced that the Subcommittee on Taxation and Tax Management will hold a hearing on tax incentives for exports.

The hearing will be held on June 18, 1979, in Room 2221, Dirksen Senate Office Building. The hearing will begin at 9:30 A.M.

The following Senate bills of general application will be examined:

S. 231, introduced by Senator Bentsen, to expand the Asset Depreciation Range (ADR) variance from 20 percent to 30 percent and to provide a simplified table for faster depreciation for small business.

S. 700, introduced by Senator Danforth, to provide a 10 percent investment tax credit for research and development expenditures.

S. 1003, introduced by Senators Bentsen and Danforth, to amend the existing bad debt and research and development provisions and to provide an annual realization for foreign currency losses.

S. 1065, introduced by Senator Danforth for himself and Senators Javits and Moynihan, to provide a credit corporations for contributions for basic research. Revenue estimates will be available at the time of the hearing.

Witnesses who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 227, Dirksen Senate Office Building, Washington, D.C. 20510, by *no later than the close of business on June 7, 1979.*

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies *by July 6, 1979,* to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

96TH CONGRESS
1ST SESSION

S. 231

To amend the Internal Revenue Code to help increase productivity and reduce inflation by providing larger tax deductions for depreciation.

IN THE SENATE OF THE UNITED STATES

JANUARY 25 (legislative day, JANUARY 15), 1979

Mr. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code to help increase productivity and reduce inflation by providing larger tax deductions for depreciation.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. INCREASE IN CLASS LIFE SYSTEM VARIANCE.**
4 (a) IN GENERAL.—Paragraph (1) of section 167(m) of
5 the Internal Revenue Code of 1954 (relating to class lives) is
6 amended by striking out "20 percent" in the text and insert-
7 ing in lieu thereof "30 percent".

II—E●

1 (b) DISREGARD OF SALVAGE VALUE.—The following
2 is inserted immediately following paragraph (3) of section
3 167(m):
4 "(4) SALVAGE VALUE DISREGARDED.—Notwith-
5 standing Subsection (f), salvage value may be disre-
6 garded in computing the allowance under this subsec-
7 tion.".
8 SEC. 2. SIMPLIFIED DEPRECIATION TABLE FOR SMALL
9 BUSINESS.
10 Section 167 of the Internal Revenue Code of 1954 is
11 amended by adding the following new subsection (q):
12 "(q) SIMPLIFIED DEPRECIATION FOR SMALL BUSI-
13 NESS.—Any business with an adjusted tax basis in assets
14 (other than real estate) of $250,000 or less shall be eligible to
15 use the following straight line depreciation table:

DEPRECIATION LIVES FOR SMALL BUSINESS ASSETS

Asset	Life
Specific depreciable assets used in all business activities:	
Office furniture and fixtures	5
Information systems (computers) and other data handling equipment	2
Airplanes	2
Automobiles	1
Buses	4
Light trucks	1
Heavy trucks	2
Truck trailers	2
Vessels and barges	9
Land improvements	14
Depreciable assets used in broad activity groups:	
Farming assets	5
Farm buildings	12
Mining	5
Construction	2
Manufacturing:	
A. Production of electronic products, textured yarn, sawmill and logging operations and oil well drilling	3

B. Production of machinery; metal, stone and clay, glass, rubber, chemical, wood, plastic, textile, apparel, leather, paper, electric and aerospace products; boat building, and printing and publishing 5
C. Production of grain, sugar and vegetable food products, tobacco products, and petroleum refining 8
Wholesale and retail trade, recreational activities, and personal and professional services 5

1 **SEC. 3. EFFECTIVE DATE.**

2 The amendments made by this bill shall apply to prop-
3 erty placed in service in taxable years beginning after De-
4 cember 31, 1978.

96TH CONGRESS
1ST SESSION

S. 700

Extending the investment credit to certain research and experimental expenditures.

IN THE SENATE OF THE UNITED STATES

MARCH 21 (legislative day, FEBRUARY 22), 1979

Mr. DANFORTH introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

Extending the investment credit to certain research and experimental expenditures.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That the Internal Revenue Code of 1954 is amended as
4 follows:
5 (a) QUALIFIED INVESTMENT FOR RESEARCH AND EX-
6 PERIMENTAL EXPENDITURE.—Paragraph (1) of section
7 46(c) (relating to qualified investment) is amended by striking
8 the period in subparagraph (B) and inserting ", plus" and

II—E

1 inserting immediately after subparagraph (B), the following
2 new subparagraph:
3 "(C) the amount of qualified research and ex-
4 perimental expenditures (as defined in section
5 48(q)) paid or incurred by the taxpayer during
6 such taxable year.".
7 (b) DEFINITIONS.—Section 48 (relating to definitions
8 and special rules) is amended by inserting immediately after
9 subsection (p), the following new subsection:
10 "(q) QUALIFIED RESEARCH AND EXPERIMENTAL EX-
11 PENDITURES.—For purposes of this subpart, the term 'quali-
12 fied research and experimental expenditures' has the same
13 meaning as the phrase 'research and experimental expendi-
14 tures' contained in section 174.".
15 (c) EFFECTIVE DATE.—The amendments made by this
16 section shall apply to expenditures made in taxable years be-
17 ginning after December 31, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1003

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of certain items relating to export activities of American firms.

IN THE SENATE OF THE UNITED STATES

APRIL 25 (legislative day, APRIL 9), 1979

Mr. BENTSEN (for himself and Mr. DANFORTH) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of certain items relating to export activities of American firms.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. REASONABLE ESTIMATION OF BAD DEBT RE-**
4 **SERVES FOR EXPORT RECEIVABLES.**
5 Subsection (c) of section 166 of the Internal Revenue
6 Code of 1954 (relating to reserve for bad debts) is amended
7 to read as follows:
8 "(c) RESERVE FOR BAD DEBTS.—

II

96TH CONGRESS
1ST SESSION

S. 935

To amend the Internal Revenue Code of 1954 to provide an election to depreciate property eligible for the investment credit over 5 years, to allow the amortization of pollution control equipment over 2 years, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 10 (legislative day, APRIL 9), 1979

Mr. CHAFEE introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide an election to depreciate property eligible for the investment credit over 5 years, to allow the amortization of pollution control equipment over 2 years, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Capital Cost Recovery
4 Act of 1979".
5 SEC. 2. (a) Section 167 of the Internal Revenue Code of
6 1954 (relating to depreciation) is amended by redesignating

1 subsection (r) as subsection (s) and by inserting after subsec-
2 tion (q) the following new subsection:
3 "(r) 5-YEAR USEFUL LIFE FOR CERTAIN SECTION 38
4 PROPERTY.—
5 "(1) IN GENERAL.—In the case of any eligible
6 property, the taxpayer may elect, for purposes of com-
7 puting the depreciation deduction allowed by subsec-
8 tion (a), to treat such property as having a useful life
9 of not less than 5 years.
10 "(2) HALF-YEAR CONVENTION REQUIRED.—If
11 the taxpayer elects under paragraph (1) to have this
12 subsection apply with respect to any eligible property
13 during the taxable year, all eligible property placed in
14 service by the taxpayer during the taxable year (re-
15 gardless of whether this subsection applies to such
16 property) shall be treated as having been placed in
17 service on the first day of the second half of the tax-
18 able year.
19 "(3) ELIGIBLE PROPERTY.—For purposes of this
20 subsection, the term 'eligible property' means section
21 38 property (within the meaning of section 48(a)) other
22 than property described in subparagraphs (C), (D), and
23 (E) of section 48(a)(1).
24 "(4) ELECTION.—

1 "(A) IN GENERAL.—An election under this
2 subsection shall be made at such time and such
3 manner as may be prescribed by the Secretary by
4 regulations.
5 "(B) TERMINATION.—A taxpayer may ter-
6 minate, in such manner as may be prescribed by
7 the Secretary by regulation, any election made
8 under this subsection for any taxable year at any
9 time on or before the earlier of—
10 "(i) the date on which he files a return
11 of tax for such year, or
12 "(ii) the due date for filing such return
13 (determined with regard to any extensions of
14 time for filing).
15 "(C) REVOCATION.—Subject to any period
16 of limitations, a taxpayer may revoke any election
17 in effect under this subsection for any taxable
18 year, but only with the consent of the Secre-
19 tary.".
20 (b) Subsection (d) of section 179 of such Code (relating
21 to additional first-year depreciation allowance for small busi-
22 ness) is amended by adding at the end thereof the following
23 new paragraph:
24 "(10) COORDINATION WITH SECTION 167(r).—
25 Section 179 property shall not include any property

1 with respect to which an election is made under sec-
2 tion 167(r).".
3 SEC. 3. (a) Subsection (a) of section 169 of the Internal
4 Revenue Code of 1954 (relating to amortization of pollution
5 control facilities) is amended by striking out "60 months"
6 and inserting "24 months".
7 (b) Subsections (a) and (b) of such section 169 are each
8 amended by striking out "60-month" and inserting "24-
9 month".
10 (c) Paragraph (4) of section 57(a) of such Code (relating
11 to items of tax preference) is repealed.
12 SEC. 4. The amendments made by this Act shall apply
13 to property placed in service on or after the date of enact-
14 ment of this Act.

1 "(1) GENERAL RULE.—In lieu of any deduction
2 under subsection (a), there shall be allowed (in the dis-
3 cretion of the Secretary) a deduction for a reasonable
4 addition to a reserve for bad debts.
5 "(2) REASONABLE ESTIMATION FOR BAD DEBTS
6 IN CONNECTION WITH EXPORTS.—
7 "(A) SEPARATE RESERVE.—A taxpayer en-
8 gaged in the trade or business of selling export
9 property or services for use outside the United
10 States may establish a separate reserve for bad
11 debts with respect to that trade or business.
12 "(B) ANNUAL ADDITION.—The amount
13 added to any such separate reserve for the taxable
14 year shall not exceed the greater of—
15 "(i) 15 percent of the taxable income
16 from sources without the United States
17 (within the meaning of section 862(b)) for the
18 taxable year attributable to such trade or
19 business, or
20 "(ii) 2 percent of the taxpayer's export
21 receivables outstanding as of the close of the
22 taxable year.
23 "(C) MAXIMUM RESERVE.—No amount may
24 be added to any such reserve for the taxable year
25 which would cause the total amount credited to

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1 the reserve as of the close of the taxable year to
2 exceed 5 percent of the taxpayer's export receiv-
3 ables outstanding as of the close of the taxable
4 year.
5 "(D) DEFINITIONS.—For purposes of this
6 paragraph—
7 "(i) EXPORT RECEIVABLES.—The term
8 'export receivables' means accounts receiv-
9 able for export receipts.
10 "(ii) EXPORT RECEIPTS.—The term
11 'export receipts' means gross receipts from
12 the sale of export property or services for
13 use outside the United States.
14 "(iii) EXPORT PROPERTY.—The term
15 'export property' has the same meaning as
16 such term has in section 971(e).".
17 **SEC. 2. CLARIFICATION OF TAX TREATMENT OF CERTAIN RE-**
18 **SEARCH AND EXPERIMENTAL EXPENDITURES.**
19 Section 174 of the Internal Revenue Code of 1954 (re-
20 lating to research and experimental expenditures) is amended
21 by redesignating subsection (e) as (f), and by inserting imme-
22 diately after subsection (d) the following new subsection:
23 "(e) CERTAIN EXPORT-RELATED EXPENDITURES.—
24 At the election of the taxpayer, made in accordance with
25 regulations prescribed by the Secretary, amounts paid or in-

1 curred for the following items may be treated as research or
2 experimental expenditures under subsection (a) or (b):
3 "(1) FOREIGN MARKET STUDIES, ETC.—Amounts
4 paid or incurred in connection with the survey or anal-
5 ysis of foreign markets and products.
6 "(2) FOREIGN MARKETING EXPENSES.—
7 Amounts paid or incurred in connection with market-
8 ing, outside the United States, goods produced in the
9 United States, including, but not limited to, amounts
10 paid or incurred in adapting United States products to
11 meet foreign market requirements.
12 "(3) FOREIGN PATENT COSTS.—Amounts paid or
13 incurred in connection with the application for, or
14 maintenance of, international and foreign patents and
15 trademarks (without regard to whether the taxpayer is
16 the owner of, or the owner of the rights to, the United
17 States patent for the item) for use in the taxpayer's
18 trade or business.".
19 **SEC. 3. CLARIFICATION OF THE TAX TREATMENT OF FOR-**
20 **EIGN CURRENCY FLUCTUATION LOSSES ON**
21 **EXPORT RECEIVABLES.**
22 Section 165 of the Internal Revenue Code of 1954 (re-
23 lating to losses) is amended by redesignating subsection (i) as
24 (j), and by inserting after subsection (h) the following new
25 subsection:

1 "(i) LOSSES ATTRIBUTABLE TO FOREIGN CURRENCY
2 FLUCTUATIONS ON EXPORT RECEIVABLES.—
3 "(1) GENERAL RULE.—At the election of the tax-
4 payer, there shall be allowed as a deduction an amount
5 equal to the foreign currency fluctuation loss of the
6 taxpayer for the taxable year with respect to export
7 receivables. The election shall be made at such time
8 and in such manner as the Secretary may prescribe,
9 and may be made on a currency-by-currency basis.
10 "(2) DEFINITIONS; SPECIAL RULES.—For pur-
11 poses of this subsection—
12 "(A) FOREIGN CURRENCY FLUCTUATION
13 LOSS.—The term 'foreign currency fluctuation
14 loss' means the amount by which the value,
15 stated in United States dollars, of an export re-
16 ceivable, payable in foreign currency, on the later
17 of—
18 "(i) the first day of the taxable year, or
19 "(ii) the date on which the export re-
20 ceivable was created,
21 exceeds the value of the export receivable, stated
22 in United States dollars, on the last day of the
23 taxable year.

1 "(B) EXPORT RECEIVABLE.—The term
2 'export receivable' has the same meaning as in
3 section 166(c)(2)(D)(i).
4 "(C) DEDUCTION ALLOWED ONLY TO TAX-
5 PAYER WHOSE TRADE OR BUSINESS CREATED
6 THE EXPORT RECEIVABLE.—The deduction al-
7 lowed by this subsection shall be allowed only to
8 the taxpayer whose trade or business created the
9 export receivable with respect to which the de-
10 duction is allowable.
11 "(3) RECAPTURE UPON RECEIPT.—If the amount
12 received by the taxpayer in satisfaction of an export
13 receivable exceeds—
14 "(A) the value of that receivable, stated in
15 United States dollars, on the date on which it was
16 created, reduced by
17 "(B) the sum of the amounts allowed for all
18 taxable years under this subsection with respect
19 to that receivable,
20 then, for purposes of this chapter, the amount realized
21 by the taxpayer in satisfaction of that receivable shall
22 be increased by the amount of such excess.
23 "(4) APPLICATION WITH SECTION 166.—For the
24 purpose of determining the amount of the deduction al-
25 lowable under section 166(a) for any taxable year for a

1 debt which is an export receivable for which a deduc-
2 tion has been claimed under this subsection, the adjust-
3 ed basis shall be reduced by the sum of any deductions
4 allowed under this subsection for that and all prior tax-
5 able years.

6 "(5) REGULATIONS.—The Secretary shall pre-
7 scribe such regulations as may be necessary to carry
8 out the provisions of this subsection.".

9 **SEC. 4. EFFECTIVE DATE.**

10 The amendments made by this Act apply with respect
11 to taxable years beginning after September 30, 1980.

II

96TH CONGRESS
1ST SESSION

S. 1065

To amend the Internal Revenue Code of 1954 to provide an income tax credit to corporations for contributions for basic research.

IN THE SENATE OF THE UNITED STATES

MAY 3 (legislative day, APRIL 9), 1979

Mr. DANFORTH (for himself, Mr. JAVITS, and Mr. MOYNIHAN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide an income tax credit to corporations for contributions for basic research.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. BASIC RESEARCH CREDIT.**
4 (a) IN GENERAL.—Subpart A of part IV of subchapter
5 A of chapter 1 (relating to credits) is amended by inserting
6 after section 44C the following new section:

1 "SEC. 44D. BASIC RESEARCH CREDIT.

2 "(a) In the case of a corporation, other than an electing
3 small business corporation (as defined in section 1371), there
4 shall be allowed a credit against the tax imposed by this
5 chapter for the taxable year an amount equal to 25 percent
6 of—

7 "(1) the excess of the qualified basic research con-
8 tributions for the taxable year over the average quali-
9 fied basic research contributions, reduced by

10 "(2) the excess of the average charitable contribu-
11 tions over the charitable contribution for the taxable
12 year.

13 "(b) APPLICATION WITH OTHER CREDITS.—The
14 credit allowed by subsection (a) shall not exceed the tax im-
15 posed by this chapter for the taxable year, reduced by the
16 sum of the credits allowable under a section of this subpart
17 having a lower number or letter designation than this section,
18 other than credits allowable by sections 31, 39, and 43.

19 "(c) DEFINITIONS.—For purposes of this section—

20 "(1) QUALIFIED BASIC RESEARCH CONTRIBU-
21 TION.—The term 'qualified basic research contribution'
22 means an amount of cash paid during the taxable year
23 for which a deduction is allowed under section 170 to
24 an educational organization (other than a primary or
25 secondary school) and which is required, as a condition

1 of the transfer, to be used exclusively for scientific
2 basic research.
3 "(2) AVERAGE QUALIFIED BASIC RESEARCH
4 CONTRIBUTIONS.—The term 'average qualified basic
5 research contributions' means one fourth of the sum of
6 the qualified basic research contributions made by the
7 taxpayer during the four preceding taxable years.
8 "(3) AVERAGE CHARITABLE CONTRIBUTIONS.—
9 The term 'average charitable contributions' means one-
10 fourth of the sum of the deductions allowable under
11 section 170 to the taxpayer (other than qualified basic
12 research contributions) for the four preceding taxable
13 years.
14 "(4) CHARITABLE CONTRIBUTIONS.—The term
15 'charitable contribution' means the amount of deduction
16 allowable under section 170 to the taxpayer (other
17 than deductions allowable for qualified basic research
18 contributions).
19 "(5) SCIENTIFIC BASIC RESEARCH.—The term
20 'scientific basic research' means fundamental research
21 in the physical sciences the results of which are freely
22 available to the general public.
23 "(d) SPECIAL RULES.—
24 "(1) CONTROLLED GROUP OF CORPORATIONS.—
25 For purposes of this section, all members of the same

1 controlled group of corporations shall be treated as one
2 corporation to which this section applies. In any such
3 case, the credit (if any) allowable by this section to
4 each such member shall be its proportionate contribu-
5 tion of qualified basic research contributions giving rise
6 to such credit. For purposes of this paragraph, the
7 term 'controlled group of corporations' has the mean-
8 ing given to such term by section 1561(a), except
9 that—
10 "(i) 'more than 50 percent' shall be substitut-
11 ed for 'at least 80 percent' each place it appears
12 in section 1563(a)(1), and
13 "(ii) the determination shall be made without
14 regard to subsections (a)(4) and (e)(3)(C) of section
15 1563.
16 "(2) ADJUSTMENT FOR CERTAIN ACQUISITIONS,
17 ETC.—Under regulations prescribed by the Secre-
18 tary—
19 "(i) ACQUISITIONS.—If a taxpayer acquires
20 the major portion of a trade or business of another
21 person (hereinafter in this clause referred to as
22 the 'predecessor') or the major portion of a sepa-
23 rate unit of a trade of business of a predecessor,
24 then, for purposes of applying this section for any
25 year ending after such acquisition, the qualified

1 basic research contributions and the charitable
2 contributions of the taxpayer shall be increased by
3 so much of the qualified basic research contribu-
4 tions and the charitable contributions paid by the
5 predecessor with respect to the acquired trade of
6 business as is attributable to the portion of such
7 trade or business acquired by the taxpayer.
8 "(ii) DISPOSITIONS.—If—
9 "(I) a taxpayer disposes of the major
10 portion of any trade or business of the tax-
11 payer or the major portion of a separate unit
12 of a trade or business of the employer in a
13 transaction to which subparagraph (i) applies,
14 and
15 "(II) the taxpayer furnishes the acquir-
16 ing person with such information as is neces-
17 sary for the application of subparagraph (i),
18 then, for purposes of applying this section to
19 any year after such disposition, the amount
20 of qualified basic research contributions and
21 charitable contributions paid by the taxpayer
22 during periods before such disposition shall
23 be decreased by so much of such qualified
24 basic research contributions and charitable

1 contributions as is attributable to such trade
2 or business or separate unit.
3 "(3) TAX-EXEMPT ORGANIZATIONS.—No credit
4 shall be allowed under this section to any corporation
5 (other than a cooperative described in section 521)
6 which is exempt from income tax under this chapter.".
7 (b) TECHNICAL AND CONFORMING AMENDMENTS.—
8 The table of sections for subpart A of part IV of subtitle A of
9 the Code is amended by inserting after section 44C the fol-
10 lowing:

"Sec. 44D. Basic Research Credit.".

11 **SEC. 2. EFFECTIVE DATE.**

12 (a) GENERAL RULE.—The amendment made by section
13 1 of this Act shall apply to taxable years beginning after
14 December 31, 1979.
15 (b) TRANSITIONAL RULE.—For taxable years begin-
16 ning before January 1, 1984, the average qualified basic re-
17 search contributions shall be determined by dividing the sum
18 of qualified basic research contributions made in preceding
19 taxable years beginning after December 31, 1979, by the
20 number of such preceding taxable years.

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

The continuing American trade deficit is a discouraging figure for all Americans. In 1978, the trade deficit was $28.5 billion. During the first part of 1979, we have continued to be in a deficit position by $6.2 billion for the first quarter. Today, there is a heated and extensive debate over what must be done to encourage American exports and reduce the trade deficit.

Many courses of action have been suggested.

The subcommittee hearings today will focus upon tax incentives to encourage exports. The proposal deals with many different types of such incentives ranging from measures which permit faster depreciation of business equipment to tax deductions and tax credit for research and development expenditures and contributions.

While each of these measures is important, a single factor stands out as being most significant. This is a need to reduce the rate of inflation in the United States.

In 1978, inflation increased at a rate of 9 percent. During 1979, the inflation rates continue to be high. Domestic inflation has a serious impact upon American exports. As the price of American goods go up, they become less and less competitive with foreign goods.

No easy or simple cures exist for the problems of inflation. Measures designed to increase American productivity through tax incentives are part of the solution. Productivity increases will help deflate the inflation caused by large wage increases.

Furthermore, a greater supply of goods will also tend to bring prices down.

While tax incentives play an important role in improving our Nation's capital investment, a reduction in the rate of Government spending is, in my mind, the single most important policy direction which we must take. In fiscal year 1978, Government spending increased by 12 percent. A 7.5 percent increase in spending is estimated for fiscal year 1979 and spending will increase by 8.4 percent in 1980.

Government spending financed by year after year of Government deficit has led to year after year of inflation. American trade, and growth of American exports, will depend ultimately upon the fundamental soundness of our domestic economy. Continued inflation and budget deficits will only further erode international confidence in our economy and make American exports more costly and less competitive and undermine the strength of the dollar.

Fiscal discipline at home is a necessary element for the future success of American exports.

Now, the bills under consideration today are S. 231, introduced by the distinguished Senator from Texas, Mr. Bentsen; S. 935, introduced by the distinguished Senator from Rhode Island, Mr. Chafee; S. 700, introduced by the distinguished Senator from Missouri, Mr. Danforth; S. 1003, introduced by the Senator from Texas, Mr. Bentsen, and the Senator from Missouri, Mr. Danforth; and S. 1065, introduced by the Senator from Missouri, Mr. Danforth and the two Senators from New York, Mr. Javits and Mr. Moynihan.

Senator Bentsen, do you have comments, before we proceed with the witnesses?

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

What has happened to the American trade balance has had its effect on the value of the dollar and has contributed to inflation. There are not going to be any quick fixes for this problem. We are a country that has really not concentrated on exports. We need a true advocate when we talk about building exports for this country of ours. We need a department of trade. We need someone who points out how important it is to the value of the American dollar that we increase our exports.

I agree with Senator Byrd that the problems of trade and inflation are tied together. But I believe also that the problems of productivity and trade are tied together.

Last year, this country's productivity increased by eight-tenths of 1 percent, the Japanese by 8 percent.

We still have the greatest productivity of any major nation in the world, but the trend lines are alarming and they are changing rapidly, and it means that we need to make some very substantive changes in the economic direction of this country.

One of the things that we have to do is to substantially increase depreciation schedules in this country so you have the cash flow for the modernization of productive capacity. This country has invested the smallest percentage of real national output back into the modernization of its productive capacity of any major industrialized nation in the world. The country next to us is England—you can see their problems. The country that put the highest percentage back in was Japan.

Greater capital formation is desperately needed in this country. We started hearings on this problem 4 years ago in this committee.

We have the smallest percentage of savings of any major nation in the world. The country that has the largest percentage of savings is, again, Japan. We have had tax policies that have penalized savings and capital formation, and we have tried to encourage consumption for 30 years in this country.

It is time to turn that around. The Joint Economic Committee of Congress has had some lengthy studies on that in its annual report. It has talked about the major substantive changes that have to be made by concentration on the supply side of the economy. That is what some of these bills do.

Senator Danforth and I have introduced a series of proposals, and I have introduced some additional ones, to make major substantive changes in the economic direction of this country. This committee is going to have a primary responsibility for them.

The Senate Finance Committee has that jurisdiction and has the kind of expertise on the staff and in the membership to help bring that about.

Thank you very much.

Senator BYRD. Thank you, Senator Bentsen.

Like you, I think it is vitally important to concentrate on productivity. It is absolutely essential that there be an increase in productivity in our Nation.

Now, the first witness today will be Hon. Emil Sunley, Deputy Assistant Secretary for Tax Analysis, Department of the Treasury.

I would ask the first three witnesses if they would confine their formal statements to 15 minutes.

Mr. Sunley, you may proceed as you wish.

STATEMENT OF EMIL SUNLEY, DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, DEPARTMENT OF THE TREASURY

Mr. SUNLEY. Thank you, Mr. Chairman, and members of this committee.

The various tax incentives for exports that this committee is considering today should be evaluated in light of the improved competitive position of the U.S. economy in world markets. While the administration remains concerned over the size of the trade and current account deficits, both have been reduced significantly.

In the first quarter of 1979, nonagricultural export volume was up 22 percent from 1 year earlier, while nonoil import volume increased only 1 percent. Our balance of trade in these categories, expressed on an annual rate basis, improved by $22 billion over that period.

We expect these elements of the international outlook to continue to improve in 1979. Since trade volumes adjust relatively slowly to changes in relative prices, last year's depreciation of the dollar will continue to expand exports and restrain imports in the months ahead. The administration's anti-inflation program will also strengthen our international competitiveness.

Other policies and programs have been initiated to improve the trade picture. In recognition of the importance of exports to the U.S. economy, President Carter announced a national export policy in September 1978. This policy includes: A $500 million increase in loan authority of the Eximbank; a commitment from the Small Business Administration to channel up to $100 million of its loan guarantees to small exporters; the earmarking of $20 million of the Commerce and State Departments' budgets to assist small- and medium-sized businesses in their marketing efforts abroad; and a review of administration and regulatory actions which adversely affect exports.

The recently concluded multilateral trade negotiations will also pave the way for the continued expansion of trade. The new agreements provide a substantial reduction in industrial tariffs, and also new codes that will significantly reduce nontariff barriers to trade. Especially important is the new code on subsidies and countervailing measures. This code will bring much-needed discipline to one of the most contentious areas of Government intervention in trade. Its intent is to facilitate trade through the reduction and elimination of export incentives and subsidies.

Because export industries will be the clear beneficiaries of the MTN, new tax incentives for these same industries may be neither appropriate nor necessary. Indeed, the proposed export tax incentives would seem to violate the spirit, and perhaps the letter, of the new code. For the United States, the lowering of our own import barriers will help reduce inflationary pressures by increasing competition; our exports will benefit from the reduction of tariff and nontariff barriers in major export markets.

The overall size of the trade deficit continues to depend upon the dollar value of our oil imports. The President's new energy program is designed to reduce oil import volume by 1 million barrels a

day by 1985. The phased decontrol of oil prices will increase domestic oil production, encourage conservation of energy supplies, and promote the use of alternative energy sources. The energy security trust fund, which will be financed by the windfall profits tax, will finance a program of new energy initiatives and investments aimed at developing critically needed alternatives to imported oil.

The possibility that OPEC will significantly increase crude oil prices this year is the one really negative prospect for our trade balance. In 1978, the U.S. deficit for oil alone was $37.9 billion. A small percentage increase in this amount can offset much of the expected gain in nonoil export growth. This is all the more reason to avoid any actions to jeopardize the potential benefits from the MTN.

For the year 1979, we expect nonagricultural export volume to average about 12 percent higher than last year, while nonoil import volume should rise only about 2.5 percent. Overall, we expect a $27 or $28 billion trade deficit and $10 to $11 billion current account deficit in 1979. This is a major improvement from the trade and current account deficits of $34 billion and $16 billion, respectively, in 1978.

Let me comment first on the bills on export promotion, then I will turn to those relating to research and development, and conclude on the set of bills relating specifically to capital formation, although, as you realize, all of these bills are interrelated.

S. 1003 contains several provisions intended to encourage U.S. exports. A problem with some of these provisions is that they may be inconsistent with the commitments the United States has undertaken in the multilateral trade negotiations. The signatories to the subsidies/countervailing measures code agree not to grant export subsidies for products other than certain primary commodities. Among the export subsidies specifically mentioned in the annex to the code is the allowance of special tax deductions related directly to exports or export performance.

Section 1 of S. 1003 would grant a special bad debt deduction for export receivables. This is by far the most expensive section of the bill in terms of revenue cost as shown in table 1. Sections 2 and 3 of the bill may also raise objections from our trading partners. In view of the United States energetic support for multilateral action on export subsidies, any legislation which seems contrary to either the spirit or substance of the subsidies code may be unwise.

Section 2 of the bill would allow certain export market development expenses to be treated as research and experimental expenditures under section 174. Many of the eligible expenditures, however, such as for foreign market studies and foreign marketing expenses, are sales, rather than development, related. They are incurred after the R. & D. phase of a product has been completed and as its marketing is undertaken. Consequently, it would not be appropriate to treat them as R. & D. activities for tax purposes. Foreign patent application costs are also included in S. 1003, although these may already be covered by section 174. In general, the costs of obtaining a patent, such as attorney's fees expended in making and perfecting a patent application, may fall within the scope of section 174.

Section 3 of S. 1003 represents undesirable tax and economic policy. It would provide a current deduction for unrealized foreign currency losses on export receivables, even if they are covered by forward market hedges. Unrealized currency gains, however, would not be taxed. This very favorable treatment of unrealized gains and losses could encourage U.S. parent firms to transfer exchange risks back to the United States from their foreign affiliates.

Another issue for all these proposals is the cost effectiveness of tax measures to stimulate exports. The Treasury Department has concluded in its annual reports on domestic international sales corporations that the tax incentives offered by DISC's have made only a modest contribution to the growth of U.S. exports since 1971. The provisions of S. 1003, and particularly the expensive bad debt deduction, provide incentives of a type similar to DISC and can be expected to have the same limited effectiveness. The main reason for the relative inefficiency of these kinds of measures is that the tax benefits are not directed to those products that are most likely to respond to the incentives. The special bad debt deduction, for example, could particularly benefit industries with a high ratio of receivable to sales. But these may not be the industries most likely to export incentives.

Turning to research and development, this administration is firmly committed to increased Federal support for research and development. Overall, R. & D. expenditures have grown very slowly in recent years. After correcting for inflation, these expenditures in 1975 were only 2.6 percent above their level in 1965. This slow growth was largely a result of reduced Federal sponsorship of defense and aerospace related research. While private expenditures for R. & D. grew at roughly the same pace as the economy in the decade beginning in 1965, real Federal support for R. & D. declined by 1.9 percent per year. By contrast, real Federal support increased by 4.2 percent in 1977 and by 2.6 percent in 1978, while total R. & D. spending increased 4.4 percent and 2.8 percent, respectively, in these 2 years. The 2-year gain in total R. & D. spending was almost three times as great as the increase during the previous 10 years.

Recognizing the importance of basic research to innovation, the administration will continue a significant expansion in the Federal support of basic R. & D. Fiscal 1979 outlays will be about 14 percent above 1978 levels. A notable feature of the 1980 budget is the continued growth in the funding of basic research. Obligations for the conduct of basic research are estimated to be $4.6 billion in 1980. This represents an increase of $379 million, 9 percent over the 1979 dollar level, or about 2 percent in real terms.

The proposed Federal obligations for the support of all R. & D. are expected to total $30.6 billion in 1980, an increase of $1.2 billion over 1979. This includes $3.6 billion for energy reseach and technology development. Congressional passage of the windfall profits tax and the consequent creation of the energy security trust fund will allow this investment in energy R. & D. to be nearly doubled.

Research and development already receives substantial support through incentives in the Internal Revenue Code.

An income tax system that did not favor research and development relative to tangible investment would require that wages, materials, and all depreciation allocable to research and development would be charged to capital account and depreciated over the earning lifetime of the R. & D. property. Whether or not this treatment would be administratively practical, it is the appropriate standard for income tax neutrality between investments in R.& D. and investments in tangible capital.

Secton 174(a) of the Internal Revenue Code, however, permits business taxpayers to deduct research or experimental expenses in the year they are incurred. Labor and materials are expensed, while buildings and equipment are depreciated as if they were employed in current production.

As a practical matter, the present treatment of R. & D. is an administrative convenience in addition to providing an economic incentive. It avoids the complex regulations, uncertainties and rulings that could be required to distinguish research and development expenditures from current production expenses. It would be difficult, for example, to determine how much of the salaries paid to workers in "white coats" is for product development as compared to, say, quality control or market analysis.

A second type of existing tax incentive is the allowance of a tax deduction for contributions by individuals and corporations to educational and scientific orgnizations. Individual deductions are limited to 50 percent of adjusted gross income and corporate deductions to 5 percent of otherwise taxable income.

A third incentive provides that the income of scientific and educational organizations to which deductible contributions may be made is exempt from Federal income tax, except for the income an organization derives from unrelated business activities. This allows such organizations to reinvest earnings that would be subject to tax if they were engaged in manufacturing or trade.

Finally, individual inventors who sell rights to their patents are permitted to treat such revenue as capital gains even though one might consider the sale of patents to be part of the ordinary business of an inventor, and it would be so treated without the special exception provided in the law. Corporations that sell patents or license inventions do not automatically qualify for capital gains treatment, but such transactions may also be considered a sale of a capital asset and therefore eligible for capital gains treatment.

Other countries also provide tax incentives to R. & D. Generally speaking, the major trading partners of the United States tend to be more generous than the United States in providing incentives. While the United States allows some R. & D. expenditures to be deducted in the year incurred, other countries, such as Canada, extend this favorable expensing rule to capital outlays for buildings and other assets. Canada, Japan, the United Kingdom and West Germany provide various tax credits and cash grants to qualifying R. & D. expenditures. France, Japan, and West Germany provide special depreciation allowances for property devoted to R. & D.

It is not clear, however, that these incentives have had a significant impact on R. & D. spending. While R. & D. expenditures as a share of GNP have increased more rapidly in Germany and Japan

in some recent years than in the United States, the United States still ranks at the top in R. & D. as a share of GNP. Canada, in particular, has been among the most aggressive countries in promoting R. & D. Over the past two decades, Canada has provided a spectrum of tax incentives and direct financial assistance. It appears that Canadian R. & D. expenditures have not responded robustly to the incentives. The proportion of GNP devoted to R. & D. has increased only slightly and continues to be less than half that of the United States.

The premise of the incentives in S. 700, S. 1003, and S. 1065 is that export performance is closely related to levels of R. & D. spending. In this connection, I would note that while the United States does, in fact, have a trade surplus in "technology intensive" manufactured products and a trade deficit in "nontechnology intensive" manufactured products, one should be cautious in concluding that trade surpluses are the result of high levels of R. & D. spending.

For example, R. & D. may be performed in the United States while the production embodying that R. & D. may occur elsewhere. Also, because of the long lag between R. & D. and the introduction of new products, the impact, if any, of R. & D. on trade is difficult to estimate. More likely, a strong trade performance depends on a sound economy overall, including a strong world economy, rather than any one factor as specific as R. & D. spending.

The specific tax incentives being considered by this committee would raise a number of difficult administrative and definitional issues. Moreover, the increment to R. & D. effort that they might produce would be small relative to the size of subsidy provided. Most of the budget cost would be used to reward activities that would have occurred without the incentive. These proposals would also add substantive administrative complexity to the Internal Revenue Code. Let me now discuss each of the bills in turn.

S. 700 calls for a 10-percent investment tax credit for R. & D. expenditures. Eligible expenditures are defined in the bill by reference to section 174. However, this section, in fact, serves exactly the opposite purpose. Its effect, as I pointed out earlier, is specifically to avoid the need to define costs allocable to "research and development" in most cases. A taxpayer is not obliged to identify the expenses that are allocable to R. & D. since they may be currently deducted whether properly allocable to R. & D. or to activities generating current income. Under the proposed tax credit, the aforementioned problems of identifying costs allocable to research and development would be introduced.

S. 1065 would provide a 25-percent tax credit for qualifying corporate grants to colleges and universities earmarked for basic research. This would require the formulation of an administrable definition of basic research. Even if this were possible, there is probably no way to assure that the earmarking of such funds would actually increase basic research expenditures. Since basic research is a major ongoing function of colleges and universities, existing nonearmarked funds could readily be shifted to other competing educational programs.

We strongly support the idea of more money for college and university research, but the direct expenditure alternative may be

more efficient. Agencies familiar with research activities such as the National Science Foundation or the Commerce Department, would have more expertise in identifying basic research than would the Internal Revenue Service. They might also be better able to require increased effort as a condition for grants. A direct expenditure program also offers the attraction of being subject to the rigors of the normal budget appropriation process. It also is subject to administration and congressional review and oversight.

Turning now to the tax measures to stimulate capital formation, the administration has stressed repeatedly the importance of business investment in advancing our economic objectives. An increase in the rate of U.S. investment spending can be expected to improve our international competitive position. It could also increase domestic productivity and thus the growth rate of real incomes, as well as help slow inflation.

However, if we seek to promote investment through a special tax program, the offsetting revenue cost must be weighed in the balance. To realize the desired economic objectives, any such tax program must be consistent with continued improvement in the budget position. The goal of a balanced budget in fiscal 1981, which is itself important for business confidence and encouragement of private saving, is in direct competition with any substantial additional business tax reduction for 1981.

Even if you believe that budget balance must be postponed to allow additional tax reduction, we must also weigh the competing claims of individual taxpayers for income and payroll tax relief against the benefits of business tax reduction. In this regard, we should remember that the share of tax reduction in the 1978 act devoted to capital formation was very large by historical standards. Nearly half of the net tax cut produced by that act was devoted to measures that increase the returns to capital investment. These include the capital gains and minimum tax reductions, the corporate rate reductions, liberalization of the investment credit, the portion of the individual rate reductions applying to property income, and a number of small business tax provisions.

The economy is now early in the process of reacting to the large reductions in business taxes provided in the 1978 act. Recent experience continues to confirm, as economic research has repeatedly indicated, that tax incentives for investment act with a long timelag. This fact does not diminish their importance, but it does mean that we should perhaps take a longer perspective in the planning of additional investment incentives and expect to stay with the choices for some time. It is, however, not premature to be studying the alternatives now and to consider the long-term as well as short-term budget consequences of each.

I believe that it is useful to distinguish two classes of tax policy to encourage investment. The first involves general tax reduction on the rewards from owning and employing capital. These would include corporate and individual rate reductions, reduction or elimination of the double tax on corporate dividends, and more favorable treatment of household saving. This general approach often has the advantage of neutrality—that is, it is less likely to favor certain kinds of physical plant and equipment over others, or to favor particular industries over others. The other general ap-

proach to investment incentives would tie tax reduction directly to capital put in place. This type of policy is often perceived as having a quicker effect than rate reductions or saving incentives, although it may not have any larger eventual impact for an equivalent amount of annual revenue cost.

Both bills, S. 231 and S. 935, which are before us for discussion today are incentives of this second type. Either means of accelerating depreciation allowances ties the value of tax forgiveness or deferral for any company to the amount of investment put in place within a given year. Because these bills are the immediate subject of our attention, I will concentrate my remarks on investment incentives of this general type. This does not imply a preference for this type as compared to rate reduction, corporate integration, or saving relief. These more general approaches should also be included in any full evaluation of tax options to promote investment.

As a practical matter, a decision to tie tax reduction directly to annual investment expenditure probably means either increasing the investment credit or speeding up depreciation allowances. I have recently presented my views on the investment tax credit in testimony before the Subcommittee on Oversight of the House Ways and Means Committee. Let me just repeat some of the major conclusions here.

First, the investment credit stimulates investment in qualified property by reducing the cost of acquiring and using it. The credit is analagous to cash grants.

Second, the investment credit was just expanded significantly in the Revenue Act of 1978. In particular, this expansion eliminates a reduction in the credit rate, generally from 10 to 7 percent, that had been scheduled for 1981 and allows a much larger proportion of the credit earned by investment in any given year to be claimed by the taxpayer in that same year. The result is to make the credit more certain—a major factor in the effectiveness of any investment incentive. On the other hand, in spite of some liberalization in the 1978 act, the credit is still mainly restricted to investment in machinery and equipment. And because of a number of structural problems, its impact is strongest for those assets having a useful life of 7 years. Industrial structures and very short-lived machinery and equipment are left unsubsidized by the investment credit.

Third, to increase the rate of the investment credit without further structural reform would tend to magnify these defects and to increase once again the proportion of the credit that must be carried forward. Structural reform would be contentious and expensive. It is perhaps for these reasons that legislative interest seems recently to have moved from expansion of the investment credit toward liberalization of depreciation allowances as a direct investment incentive.

Accelerated depreciation reduces the cost of employing capital goods in essentially the same way as expanding the investment credit. Each may be thought of as a bonus for installing additional capacity or replacing and modernizing existing capacity. The investment credit is like a series of cash grants for initial purchase and replacement of equipment, while accelerated depreciation is more analagous to a series of interest-free loans. Of course, the amount of these interest-free loans may be set so as to have the

same equivalent cash value as any given increase in the investment credit.

However, accelerating depreciation and increasing the investment credit have different implications for the Federal budget. Since much of the revenue loss associated with accelerating depreciation is postponed to later years, it appears to have a larger "bang for the buck" at the time of enactment. Such appearances may be dangerous to long-term budget planning. Five year revenue cost projections for the specific proposals under discussion are given in table 2. These costs rise very steeply over this period.

Before discussing the two depreciation proposals being considered at this hearing, it may be helpful to review briefly the current law in this area.

CURRENT LAW REGARDING DEPRECIATION

In computing taxable income, a taxpayer is permitted a deduction for the depreciation of assets used for business or investment purposes. The imputed annual decline of asset value is regarded as a cost of doing business, similar to expenditures for utilities, wages, and maintenance. Depreciation can be computed in one of two ways: First, by reference to the facts and circumstances surrounding each item of depreciable property; and second, by using the asset depreciation range and class life (ADR) system.

Under the facts and circumstances method, a taxpayer must estimate the useful life and salvage value of each asset. Asset cost less salvage value represents the total amount to be depreciated, and useful life measures the period of depreciation. Annual deductions are then computed by a depreciation method that assumes a ratable decline in value—straight-line depreciation—or a disproportionately large decline in the early years—accelerated depreciation such as declining balance or sum of the years digits. Depreciation of individual assets through facts and circumstances estimation is usually speculative and time consuming. The determination is a source of frequent controversies between the IRS and taxpayers.

The ADR system was adopted by Treasury and ratified by Congress in 1971. Under ADR, there are over 100 guideline class lives for assets, based either upon the activity in which the assets are used—for example, mining or agriculture—or the type of asset involved—for example, automobiles or office furniture. The classes and lives are those established by Treasury under 1962 guidelines, with some modifications resulting from Treasury's examination of data collected since 1971.

Each year a taxpayer may elect whether or not to use ADR for the assets placed in service that year. If ADR is elected, the taxpayer establishes for each asset class a separate account containing only the property acquired that year—a "vintage account". As an example, a typical manufacturer of electronic products would establish a vintage account for its office furniture acquired in 1978, another account for its typewriters, an account for its automobiles, an account for its light trucks, and another account for the remainder of its assets. New vintage accounts are established for acquisitions in subsequent years.

Assets grouped in the vintage accounts are depreciated under special ADR rules, adopted in 1971 for the purpose of encouraging investment in equipment. Treasury has generally established a guideline life for each asset class that is shorter than the actual useful lives of 70 percent of all assets in that class. A taxpayer may then choose a depreciation allowance that lies within a range from 20 percent below to 20 percent above the prescribed class life, without regard to that taxpayer's particular facts and circumstances. For instance, the electronics manufacturer could use any life from 3 to 5 years for its light trucks and any life from 8 to 12 years for its office furniture. The result can be substantial tax savings as compared to determination by facts and circumstances.

PROPOSED DEPRECIATION CHANGES

S. 231 would allow the taxpayer electing the ADR depreciation system to reduce the depreciation period by 30 percent below the guideline life, instead of 20 percent as in present law. This bill also prescribes a set of shorter lives that may be taken on a straight-line method by smaller businesses having $250,000 or less of assets other than real estate.

S. 935 represents a much different approach to depreciation allowances. This bill would allow taxpayers to write off all assets now eligible for the investment credit over a 5-year period, and to write off all pollution control devices over a 2-year period. I would like briefly to compare the general approaches of these two bills without treating the specifics in any detail.

S. 231 recognizes the current problems many small businesses encounter in dealing with ADR. Only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in 1974, the latest year for which data are available. By contrast, ADR was elected in that year by over 90 percent of corporate taxpayers with depreciable assets of $1 billion or more. Undoubtedly, some taxpayers illegitimately use the short lives permitted under ADR without formally electing the system and complying with the accounting and reporting requirement. But for many small businesses, the perceived complexity of the ADR system has discouraged its use and led to a loss of tax benefits available to larger taxpayers.

Under S. 231, small businesses could use simple straight line depreciation and still obtain the tax savings otherwise available under accelerated depreciation methods. The permissible depreciation lives for small businesses would be shortened below the shortest lives allowed under ADR so that the present value of depreciation deductions would be identical under the two systems. However, the special shortening of lives would not be counted against the taxpayer in determining eligibility for the investment tax credit. Unlike some other proposals for small business benefits, this bill would not give small businesses greater tax benefits than those available to other firms. Rather, equivalent benefits would be provided in a form that makes fewer demands on taxpayer recordkeeping. As a result, this proposal should avoid the tax-sheltering problems associated with provisions that target special relief to taxpayers who satisfy prescribed eligibility criteria.

In my written statement, I also discuss the arbitrary cost-recovery system proposed by others and recognize that this would be a much more radical change in our depreciation approach as developed over the years. It would tend to favor those industries with the longer lived assets and to provide little or no benefit to industries which typically have shorter replacement periods. It would move away from trying to base the useful life for depreciation purposes on the actual anticipated future replacement pattern for each industry, and instead call for arbitrary lives to be set by Congress. Since these lives would clearly be too rapid for many industries, I believe that we would have to develop very careful rules to make sure that the system did not lead to substantial tax sheltering.

In choosing between these two depreciation methods—liberalizing the ADR system and establishing an arbitrary cost-recovery system—we have to weigh the possible gains in simplification from the arbitrary cost recovery system with the radical break with our traditional method of depreciation and possible promotion of tax sheltering.

I am sorry I have gone over my time. I must say you have a full plate of bills to try to comment on in 15 minutes.

Senator BYRD. You have done a very fine job in commenting on them, Mr. Sunley. Thank you very much.

Let me say that so far as the chairman of this subcommittee is concerned, I have taken no position on any of these pieces of legislation. I want to get the various viewpoints and the facts before making the decision as to how my one vote will be cast.

Now, Mr. Sunley, in regard to capital investment, Senator Bentsen's and Senator Chafee's proposals are directed to increasing U.S. capital investment through greater depreciation.

How do you see the linkage between greater depreciation and U.S. exports?

Mr. SUNLEY. The linkage is a long-term one. A key element in improving our export performance is the increased competitive position of the U.S. economy. Accelerated depreciation, increasing the investment credit, or other business tax reductions can reduce the tax burden on the income from capital and thus lead to increased capital-intensity of the U.S. economy, more capital per worker, improved productivity, and improve our competitive position in the world economy.

But I think that we must recognize that tax reductions to stimulate capital formation not only operate on the supply side of the economy by increasing capital formation but they also have an impact on the demand for investment. The introduction of such incentives must be carefully tied to a time when tax reduction is appropriate in the overall economy—that is, taking into account the level of unemployment, the level of inflation, and the position of the budget deficit.

Senator BYRD. What is Treasury's overall view in regard to depreciation?

Mr. SUNLEY. I think that this is one of the forms of business tax reduction that ought to be given very serious attention and it may very well be the appropriate approach, the next time that it is

desirable to have a major business tax reduction. I cannot, at this point, indicate for you just when that time is going to be.

Senator BYRD. The Chairman of the Federal Reserve Board—if I recall his words accurately, and I think I do—Mr. Miller, who has had wide experience in business besides his expertise in the position he is now in, stated recently that the country gets more bang for the buck from depreciation than any other tax proposal.

How does that statement impress you?

Mr. SUNLEY. That is a very complicated issue, Mr. Byrd. Let me see if I can address it. I made some references to that in my testimony. Let me elaborate on it.

I think when you properly measure the bucks, it is not clear that depreciation has more bang for the buck than increasing the investment credit. What happens is that for any given form of accelerating depreciation—you choose the form—I can increase the investment credit and provide the same tax reduction for business in present value terms.

Senator BYRD. Is it not correct that the investment tax credit basically is used mostly by big business and, to a much lesser extent, by small business, whereas depreciation is probably the reverse?

Mr. SUNLEY. I do not think that is so, Mr. Byrd. Either the investment credit or accelerated depreciation is a tax reduction that depends upon placing machinery and equipment in service. It is true that capital-intensive businesses benefit more than labor-intensive businesses, and capital-intensive businesses tend to be the larger businesses; but I do not see a distinction between small business and big business when it comes to choosing between the investment credit and accelerated depreciation.

If anything, the investment credit would be slightly more attractive to small business since the benefits of accelerated depreciation depend on the marginal tax rate of the business. When you provide a tax-free loan in the form of accelerating depreciation, this is worth more if you are in the 46 percent corporate tax bracket than the 20 percent corporate tax bracket.

Senator BYRD. At this point, I will ask one more question and then yield to Senator Packwood.

In your statement you say that the President's energy program will reduce oil import volume by $1 million barrels a day by 1985. I am not sure that that is a very encouraging statement to say, that his program will reduce the imports by 5 percent 6 years hence.

Mr. SUNLEY. When it comes to energy, most data are very grim. I fear that there is a long time lag between the increased incentives and increased production. The administration may have been conservative in presenting its estimates of the impact of the President's program.

Senator BYRD. It very seldom is.

Mr. SUNLEY. That may also be true, Senator Byrd, but I think these are reasonable estimates of the response to decontrol coupled with the President's proposed tax.

Senator BYRD. Thank you.

Senator Packwood?

Senator PACKWOOD. First-come-first-served. Senator Bentsen was here.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. Thank you, Mr. Chairman.

Mr. Sunley, I participated in the MTN negotiations and in the formulation of the MTN implementing legislation. I do not think that the MTN code prohibits modest tax changes.

We are talking about tax provisions already there for our competitors. One of the provisions in S. 1003—the bad-debt reserve—identical to French law.

What about the value-added tax in Europe, which is imposed on imports but rebated on exports?

Doesn't that put our country at a competitive disadvantage in trading?

I fully understand that, as a result of the negotiations, they call the value-added tax an indirect tax. I think that is an outrageous definition.

VAT was agreed to back in about 1955, as I recall, but it certainly is as direct a tax as many U.S. taxes.

How would you respond to the fact that we have copied the French law in S. 1003? We do not want more than what they give their people.

Mr. SUNLEY. Let me respond to both the MTN agreement and article IX and then that question specifically.

Article IX of the agreement states that signatories shall not grant export subsidies on products other than certain primary products. Then it says that the practices listed in the annex are illustrative of the export subsidies, such as paragraph (e), the full or partial exemption, remission or deferral, specifically related to export of direct taxes or social welfare charges paid or payable by industrial, commercial enterprises.

As I noted in my statement, section 1 of S. 1003 probably is not in conformity with this agreement. Countries are prohibited both from maintaining present subsidies or enacting new ones. The code is intended to discourage new export subsidies. Although the special problems created by existing subsidies are recognized, the code reflects the expectation that all subsidies eventually will be eliminated.

Senator BENTSEN. I do not believe that a modest change such as a tax-deductible reserve for foreign bad debts is going to be a serious problem in that regard.

If we are going to turn inflation around and take care of our trade deficit we need some major, substantive tax changes to encourage the modernization of the productive capacity in this country. That is what major changes in the depreciation schedule can bring about.

I am strongly in support of the distinguished chairman of the subcommittee here, who says he has not taken a position on any of these yet, and I want you to know I am very strongly for this, and I am going to be pushing it as hard as we can.

Mr. SUNLEY. We have worked with your staff, as you know, on developing part of your proposal.

Senator BENTSEN. We are appreciative of your assistance.

How about R. & D.? For the past 5 years, foreign citizens have won over a third of the patents given in this country. In the 1950's, we show that 82 percent of the major inventions were developed in the United States.

In the 1960's it had declined to 55 percent. In a recent study by Data Resources, a company spending heavily on R. & D. increased the productivity of the employees 75 percent.

We have a witness coming up in a few minutes who can comment to that point.

I feel very strongly that these things contribute in a major way to the increase of productivity in this country.

Thank you, Mr. Chairman.

Mr. SUNLEY. Mr. Chairman, may I comment one moment on the German value-added tax?

Senator Bentsen has made a number of valuable points, but I think that we ought to think seriously about the balance of trade effects of the value-added tax. I know you are not recommending it; you are comparing the German situation. There has been a wide political discussion on the value-added tax this year.

The key question when you introduce the value-added tax is, do you believe it will be inflationary? Japan has said the new value-added tax will be inflationary; and England last week, in raising its value-added tax—or proposing to raise it—indicated that it would add 1 or 2 percentage points to their inflation rate.

If the whole value-added tax is passed forward in higher prices and then you rebate that tax at the border, your export prices have not improved vis-a-vis other countries. You may not have as great a trade effect as some people suggest you will have from a value-added tax, if the introduction of a VAT leads to domestic inflation.

I think it is a question that has to be looked at very carefully before we decide that we have to have a value-added tax for trade reasons.

Senator BENTSEN. Mr. Chairman, that is an important subject.

Senator BYRD. It is not before the committee this morning.

Senator Packwood?

Senator PACKWOOD. Several of the witnesses who will speak subsequently say that it is necessary for this country to move toward consumption taxes and away from investment or capital taxes. Do you agree with that?

Mr. SUNLEY. I believe that that is one of the possibilities that ought to be carefully examined. We find that the key parameter in determining whether that is the correct way to go is how responsive savings will be to an improvement in its real rate of return.

There is considerable dispute within the economics profession on that issue. I would be the first to admit, however, that the economics profession is working toward the view, as compared to 10 years ago, that a greater reliance on consumption-based taxes would be appropriate; and that tax system has moved in that direction over the past 10 years as we have continually reduced the role of the corporate income tax in our tax system and increased the role of payroll taxes in our overall revenue system.

It is still an important question whether an additional movement in this direction, such as England announced last week, would have an important effect on capital formation.

Senator PACKWOOD. I agree that most economists seem to be moving in that direction. Speaking for the administration, do you think that we should move further in that direction?

Mr. SUNLEY. As I said, I think this is one of the areas that ought to be carefully reviewed. I do not, at this point, have a tax program for the administration.

We have indicated, as you well know, that we do not believe that a tax reduction is appropriate at this time, but at the time when a tax reduction is appropriate, we ought to give careful consideration to additional business tax reductions that would have the effect of reducing income taxes and shifting the burden of taxation onto consumption.

Senator PACKWOOD. You could have a shift in consumption taxes and no general tax reduction. What I am curious about is whether the administration has a tendency or a desire to move in that direction.

Mr. SUNLEY. We have a tendency to move in that direction, but at this point, we do not have a program. I think that you can talk about cutting some taxes and increasing others, but in reality we tend to wait until inflation has had an impact on the tax system, and then reduce some taxes more than others. I have some difficulty proposing a significant increase in consumption taxes to permit, at the same time, a reduction in other taxes. I do not see that as a reality this year or next. It may be a reality in 1981 or later.

Senator PACKWOOD. The reality is there is no tax policy from the administration but the status quo?

Mr. SUNLEY. The administration's tax program now is not to propose tax reductions. We want to move toward a balanced budget. We think that would have an important effect on business confidence and savings and that that goal is still achievable.

The economic situation could change. The slowdown in the economy could become more severe than the administration is predicting. Any further OPEC price increases could serve as a tax increase and would have a very detrimental effect on the economy. If the situation does change, you may want, at that point, to propose a tax reduction.

Senator PACKWOOD. Let me ask the question for the fourth time. I am not talking about a tax reduction. Does the administration have any policy of moving toward more consumption taxes so that the taxes on capital and investment might be reduced proportionately to the amount of income received from the consumption tax?

Mr. SUNLEY. The administration does not have a policy on that at this time.

Senator PACKWOOD. All right.

Senator BYRD. Senator Danforth?

Senator DANFORTH. Thank you, Mr. Chairman.

Mr. Sunley, in the state of the Union message, the President said: "I call on Congress to take other anti-inflation action to reassert our Nation's technological superiority * * * basic scientific research and development is an investment in the Nation's future," and so on.

Has the administration changed its policy since then?

Mr. SUNLEY. No; it has not, Senator Danforth. I believe the President's budget for the last several years, including this year,

has included increased Federal support of research and development.

Senator DANFORTH. You mean direct Federal grants, is that right?

Mr. SUNLEY. Yes.

Senator DANFORTH. Then the President went on to say, "We rely on industry to do its full part in the demonstration of new technologies in energy and other fields. Rather than Government funding of the research and development, companies need more favorable investment climates, better economic growth."

Has the administration changed its position on that?

Mr. SUNLEY. No.

Senator DANFORTH. As I understand it, you are opposed to everything. Is that right?

Mr. SUNLEY. I do not believe so, Senator Danforth.

Senator DANFORTH. What are you for?

Mr. SUNLEY. We are opposed——

Senator DANFORTH. What are you for?

Mr. SUNLEY. In the R. & D. tax incentive area?

Senator DANFORTH. Yes.

Mr. SUNLEY. We are opposed to targeted tax incentives for R. & D. at this time. We have not ruled out the depreciation changes that I discussed at the end of my testimony.

I remind you that the administration has had a major interagency review of technology and what can be done to encourage research and development, chaired by the Commerce Department. The business community, when they made their presentation to this interagency task force, argued very strongly that additional tax incentives for R. & D. would be a "mere tinkering at the margin"—that was their term. The business representatives suggested if we only had $500 million for increased incentives, it should be in the form of accelerating depreciation, not in the form of tax incentives for research and development.

We have, as I think I indicated today, been looking very carefully for alternative ways to stimulate general investment, although we are not very enthusiastic about targeted tax breaks for research and development.

Senator DANFORTH. Are you concerned about the trade deficit?

Mr. SUNLEY. Yes.

Senator DANFORTH. Is it not a fact that there is a relationship between research and development intensive and research and development-nonintensive businesses and how they fare in foreign trade?

We have always counted on know-how, technological superiority, and research and develoment, to provide the cutting edge for our country in foreign trade, have we not?

Mr. SUNLEY. Yes.

Senator DANFORTH. There is a statistical relationship between research and development efforts, research and development-intensive industries, and our ability to sell on a world market. Is that not correct?

Mr. SUNLEY. I am not aware of any completely definitive statistical demonstration of that sort. Investigators have found a correlation between the research intensity of an industry and its export

performance, but there are even higher correlations between export performance and other variables, such as the skill level of workers in the industry. It is therefore difficult to identify the most important forces at work. Moreover, I believe that researchers have not been able to establish a relationship between increases in R. & D. in an industry and improvements in its export performance. It is true that we have a surplus in the products of technology-intensive industry and a deficit in the products of nontechnology intensive industry.

The relationship for R. & D. which is performed in the United States and proven increases in the trade balances is fairly tenuous in the short run. It is quite possible that R. & D. performed in the United States will be embodied in goods produced abroad, while R. & D. that has occurred abroad, will be embodied in goods produced in the United States.

Senator DANFORTH. Can we not at least agree on that? Can we not at least agree that R. & D. is good? Can we not agree that R. & D. benefits our balance of trade.

Mr. SUNLEY. We can believe that R. & D. is good. Then we have to ask the question——

Senator DANFORTH. The President so stated in his state of the Union message.

Mr. SUNLEY. That is true.

You still have the question: For the next billion dollars of business tax reductions, should it be in the form of R. & D. or in more general incentives for capital formation.

Senator DANFORTH. Thank you, Mr. Chairman.

Senator BYRD. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

I would like to pursue the same line that Senator Bentsen and Senator Danforth were on. Also, I would like to recommend as standard reading the article in this month's Fortune magazine on the effects of proposition 13 in California which pretty clearly demonstrates that that economic climate was stimulated far more than anybody widely predicted, and therefore they had a better year than all the rest of the country.

What worries me about what I hear you saying from the administration is that there is only an awareness that something is going just a little bit wrong out there.

Do you agree with Senator Bentsen's assessment of reinvestment and the technology seen in America and the fact that we are losing our patent lead in the world to foreign nationals?

Mr. SUNLEY. The United States remains still the leader in the world—in terms of total expenditures on R. & D. compared to GNP—and the declines that have occurred in the United States in that area is not private R. & D., but Government-sponsored R. & D.

If you look at the privately funded R. & D. as a percent of GNP it has remained stable over the past 5 or 10 years. The decline in our total R. & D. to GNP has been in the area of Government-sponsored R. & D. In the last several years, President Carter has proposed significant increases in Government-sponsored R. & D.

We remain ahead of nearly all the other countries in the world in privately funded R. & D. It does not mean that we cannot do more; more R. & D. would be good. The question we continually

have to ask ourselves is where do you want to spend the next billion dollars, and the 10-percent tax credit in S. 700 is close to $2 billion.

Senator WALLOP. Spend the next billion dollars?

I have a bit of trouble with the way Treasury comes at this. You do not spend it until you have got it.

It is not in your pocket until it has been assessed. So when you talk about having a tax break or something, you are not spending that money. You do not have it yet.

All the product and all the goods and services of America do not belong to the Treasury Department. It belongs to America and you tax what you need to get out. Let's not call it spending. Let's say we are in the sector. We could use money that belongs to the people first.

Mr. SUNLEY. I believe we have a fundamental disagreement there, Mr. Wallop.

Senator WALLOP. You do believe that all the goods and services belong to the Treasury Department?

Mr. SUNLEY. No, I do not. No, of course not. But I think that we have to recognize that certain tax subsidies are very close to direct expenditure programs; allocating Government moneys in the form of tax subsidies, narrowly targeted tax subsidies, is no different than running a program by HEW or the Interior Department.

The Treasury Department does run the largest housing program in this Government through the various tax subsidies for housing that encourage investment in owner-occupied housing as distinct from investment in machinery and equipment.

I think it is useful in examining various proposals for narrowly targeted tax reductions, proposals to encourage people to do this or do that, to recognize that they are very similar to direct expenditure programs.

If the word "spend" offends you, then I withdraw it But I must say that when we are talking about allocating the next billion dollars of business tax reductions, we still have to ask the question: Would it be better to do it in the form of R. & D. incentives or in the form of general capital subsidies, such as increasing the investment credit or accelerating depreciation.

I would urge that this committee ask the business spokesmen today and other business spokesmen, the Business Round Table and other groups, whether narrowly targeted incentives for R. & D. or more general incentives, such as the investment credit and accelerated depreciation, would have a greater payoff in improving our capital formation and improving our balance of trade.

Senator WALLOP. The position of the administration is that it does not know?

Mr. SUNLEY. I said very clearly in my testimony that we are opposed to these specific R. & D. tax incentives. We do not believe this is an appropriate time for a tax reduction. When that appropriate time comes, the depreciation proposals that you have before your committee deserve very careful consideration; we have been studying these alternatives for the last 15 months. But you also ought to look at proposals to increase the investment tax credit, to integrate the individual and corporate income taxes and perhaps

cut the corporate income tax more than it was reduced last year. There is not a simple answer at this time.

We have two issues: First, when is a tax reduction appropriate—that is essentially a question of the state of the economy—then, what is the more appropriate reduction?

I have by no means made any statement today which would suggest that accelerated depreciation would be inappropriate when the right time comes.

Senator BYRD. Just one final question, Mr. Sunley. Specifically, what do you think should be done to encourage American exports?

Mr. SUNLEY. I think a key element in encouraging American exports is getting inflation under control. A key element of that, as you well know, Mr. Chairman, is improving the overall budget situation of the Government. I do not think at this time that a tax incentive—that that would rank 7th, 8th, 9th or 10th of things that might be done.

I think the improvement of the macroeconomy, getting inflation under control, is the key element and not additional tax incentives targeted at exports.

Senator BYRD. Thank you, Mr. Sunley.

Senator Bentsen?

Senator BENTSEN. Mr. Chairman, Mr. Sunley, you have covered your subject well, and I appreciate that. I understand the question of timing is what troubles you on these tax cuts, trying to decide when—I have a hunch we may have to do that earlier than some think. But I read the article in the New York Times this morning that says the Treasury is working on a new study for social security funding and depreciation allowances for business; that the Treasury is arguing for more rapid depreciation to spur plant and equipment spending and build up the supply side of the economy to help check inflation.

I think that is a grand statement. Thank you very much.

Senator BYRD. Thank you, Mr. Sunley.

[The prepared statement of Mr. Sunley follows:]

STATEMENT OF EMIL M. SUNLEY, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and Members of this distinguished Committee:

IMPROVED INTERNATIONAL OUTLOOK

The various tax incentives for exports that this Committee is considering today should be evaluated in light of the improved competitive position of the U.S. economy in world markets. While the Administration remains concerned over the size of the trade and current account deficits, both have been reduced significantly in the past year. As growth abroad has accelerated and foreign currency values have increased, our nonagricultural exports and nonoil imports have responded dramatically. In the first quarter of 1979, for example, nonagricultural export volume was up 22 percent from 1 year earlier, while nonoil import volume increased only 1 percent. Our balance of trade in these categories (expressed on an annual rate basis) improved by $22 billion over that period.

We expect these elements of the international outlook to continue to improve in 1979. Since trade volumes adjust relatively slowly to changes in relative prices, last year's depreciation of the dollar will continue to promote expansion of exports and restrain imports in the months ahead. The Administration's anti-inflation program will also strengthen our international competitiveness.

Other policies and programs have been initiated to improve the trade picture. In recognition of the importance of exports to the U.S. economy, President Carter announced a National Export Policy in September 1978. This policy includes: a $500

million increase in loan authority of the Eximbank; a commitment from the Small Business Administration to channel up to $100 million of its loan guarantees to small exporters; the earmarking of $20 million of the Commerce and State Department's budgets to assist small- and medium-sized businesses in their marketing efforts abroad; and a review of administration and regulatory actions which adversely affect exports.

The recently concluded Multilateral Trade Negotiations (MTN) will also pave the way for the continued expansion of trade. The new agreements provide a substantial reduction in industrial tariffs, and also new codes that will significantly reduce nontariff barriers to trade. Especially important is the new code on subsidies and countervailing measures. This code will bring much needed discipline to one of the most contentious areas of Government intervention in trade. Its intent is to facilitate trade through the reduction and elimination of export incentives and subsidies.

Because export industries will be the clear beneficiaries of the MTN, new tax incentives for these same industries may be neither appropriate nor necessary. Indeed the proposed export tax incentives would seem to violate the spirit, and perhaps the letter, of the new code. For the United States, the lowering of our own import barriers will help reduce inflationary pressures by increasing competition; our exports will benefit from the reduction of tariff and nontariff barriers in major export markets.

The overall size of the trade deficit continues to depend upon the dollar value of our oil imports. The President's new energy program is designed to reduce oil import volume by 1 million barrels a day by 1985. The phased decontrol of oil prices will increase domestic oil production, encourage conservation of energy supplies, and promote the use of alternative energy sources. The Energy Security Trust Fund, which will be financed by the windfall profits tax, will finance a program of new energy initiatives alternatives to imported oil.

The possibility that OPEC will significantly increase crude oil prices this year is the one really negative prospect for our trade balance. In 1978, the U.S. deficit for oil alone was $37.9 billion. A small percentage increase in this amount can offset much of the expected gain in nonoil export growth. This is all the more reason to avoid any action's to jeopardize the potential benefits from the MTN.

For the year 1979, we expect nonagricultural export volume to average about 12 percent higher than last year, while nonoil import volume should rise only about 2½ percent. Overall, we expect a $27 or $28 billion trade deficit and $10 to $11 billion current account deficit in 1979. This is a major improvement from the trade and current account deficits of $34 billion and $16 billion, respectively, in 1978.

SPECIFIC PROPOSALS FOR EXPORT PROMOTION

S. 1003 contains several provisions intended to encourage U.S. exports. A problem with some of these provisions is that they may be inconsistent with the commitments the U.S. has undertaken in the Multilateral Trade Negotiations. The signatories to the Subsidies/Countervailing Measures Code agree not to grant export subsidies for products other than certain primary commodities. Among the export subsidies specifically mentioned in the Annex to the Code is the allowance of special tax deduction for export receivables. This is also by far the most expensive section of the bill in terms of revenue cost as shown in Table 1. Sections 2 and 3 of the bill

TABLE 1.—REVENUE COST OF BILL S. 1003

[In millions of dollars]

	1980	1981	1982	1983	1984	1985
Special deduction for bad debts	[1]106	116.6	128.3	35.1	38.6	42.5
Expensing of certain R & D costs	5	5.0	5.0	5.0	5.0	5.0
Deduction of unrealized currency losses in export receivables	10	1.0	1.1	1.2	1.3	1.4
Total	121	122.6	134.4	41.3	44.9	48.9

[1] This estimate assumes that firms choose to add 2 percent of export receivables to a bad debt reserve If they alternatively choose to deduct 15 percent of foreign source income, the main impact would be on the time phasing of revenue losses because of the 5 percent limit on the bad debt reserve.

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may also raise objection from our trading partners. In view of the United States' energetic support for multilateral action on export subsidies, any legislation which seems contrary to either the spirit and substance of the Subsidies Code may be unwise.

Section 2 of the bill would allow certain export market development expenses to be treated as research and experimental expenditures under section 174. Many of the eligible expenditures, however, such as for foreign market studies and foreign marketing expenses, are sales, rather than development, related. They are incurred after the R&D phase of a product has been completed and as its marketing is undertaken. Consequently, it would not be appropriate to treat them as R&D activities for tax purposes. Foreign patent application costs are also included in S. 1003 although these may already be covered by section 174. In general, the costs of obtaining a patent, such as attorney's fees expended in making and perfecting a patent application, may fall within the scope of section 174.

Section 3 of S. 1003 represents undesirable tax and economic policy. It would provide a current deduction for unrealized foreign currency losses on export receivables even if they are covered by forward market hedges. Unrealized currency gains, however, would not be taxed. This very favorable treatment of unrealized gains and losses could encourage U.S. parent firms to transfer exchange risks back to the U.S. from their foreign affiliates.

Another issue for all these proposals is the cost effectiveness of tax measures to stimulate exports. The Treasury Department has reported in its annual reports on Domestic International Sales Corporations that the tax incentives offered by DISCs have made only a modest contribution to the growth of U.S. exports since 1971. The provisions of S. 1003, and particularly the expensive bad debt deduction provide incentives of a type similar to DISC and they can be expected to have the same limited effectiveness. The main reason for the relative inefficiency of these kinds of measures is that the tax benefits are not directed to those products that are most likely to respond to the incentives. For example, the special bad debt deduction could particularly benefit industries with a high ratio of receivables to sales. This is not a criterion for judging the response to export incentives.

RESEARCH AND DEVELOPMENT

This Administration if firmly committed to increasing Federal support for research and development. Overall, R&D expenditures have grown very slowly in recent years. After correcting for inflation, these expenditures in 1975 were only 2.6 percent above their level in 1965. This slow growth was largely a result of reduced Federal sponsorship of defense and aerospace related research. While private expenditures for R&D grew at roughly the same pace as the economy in the decade beginning in 1965, real Federal support for R&D declined by 1.9 percent per year. By contrast, real Federal support was increased by 4.2 percent in 1977 and by 2.6 percent in 1978, while total R&D spending increased 4.4 percent and 2.8 percent respectively in these 2 years. The 2-year gain in total R&D spending was almost 3 times as great as the increase during the previous 10 years.

Recognizing the importance of basic research to innovation, the Administration will continue a significant expansion in the Federal support of basic R&D. Fiscal 1979 outlays will be about 14 percent above 1978 levels. A notable feature of the 1980 budget is the continued growth in the funding of basic research. Obligations for the conduct of basic research are estimated to be $4.6 billion in 1980. This represents an increase of $379 million, 9 percent over the 1979 dollar level, or about 2 percent in real terms.

The proposed Federal obligations for the support of all R&D are expected to total $30.6 billion in 1980, an increase of $1.2 billion over 1979. This includes $3.6 billion for energy research and technology development. Congressional passage of the windfall profits tax and the consequent creation of the Energy Security Trust Fund will allow this investment in energy R&D to be nearly doubled.

Research and development already receives substantial support through incentives in the Internal Revenue Code.

An income tax system that did not favor research and development relative to tangible investment would require that all expenses associated with an R&D project be capitalized. In the case of research and development expenses, this would require that wages, materials, and all depreciation allocable to research and development would be charged to capital account and depreciated over the earning lifetime of the R&D "property". Whether or not this treatment would be administratively practical, this treatment is the appropriate standard for income tax neutrality between investments in R&D and investments in tangible capital.

Section 174(a) of the Internal Revenue Code, however, permits business taxpayers to deduct research or experimental expenses in the year they are incurred. Labor and materials are expensed, while buildings and equipment are depreciated as if they were employed in current production.

As a practical matter, the present treatment of R&D is an administrative convenience in addition to providing economic incentive. It avoids the complex regulations, uncertainties and rulings that would be required to distinguish research and development expenditures from current production expenses. It would be difficult to determine how much of the salaries paid to workers in "white coats" goes to product development as compared to, say, quality control or market analysis.

A second type of existing tax incentive is the allowance of a tax deduction for contributions by individuals and corporations to educational and scientific organizations. Individual deductions are limited to 50 percent of adjusted gross income, corporate deductions to 5 percent of otherwise taxable income.

Third, the income of scientific and educational organizations to which deductible contributions may be made is exempt from Federal income tax, except for the income an organization derives from "unrelated" business activities. This allows such organizations to reinvest earnings that would be subject to tax if they were engaged in manufacturing or trade.

Finally, individual inventors who sell rights to their patents are permitted to treat such revenue as capital gains even though one might consider the sale of patents is part of the ordinary business of an inventor, and it would be so treated without the special exception provided in the law. Corporations that sell patents or license inventions do not automatically qualify for capital gains treatment, but such transactions may also be considered a sale of a capital asset and therefore eligible for capital gains treatment.

Other countries also provide tax incentives to R&D and, generally speaking, the major trading partners of the United States tend to be more generous than the United States. While the United States allows some R&D expenditures to be deducted in the year incurred, other countries, such as Canada, extend this favorable expensing rule to capital outlays for buildings and other assets. Canada, Japan, the United Kingdom and West Germany provide various tax credits and cash grants to qualifying R&D expenditures. France, Japan, and West Germany provide special depreciation allowances for property devoted to R&D.

It is not clear, however, that these incentives have had a significant impact on R&D spending. While R&D expenditures as a share of GNP have increased more rapidly in Germany and Japan in some recent years than in the United States, the United States still ranks at the top in R&D as a share of GNP.[1] Canada, in particular, has been among the most aggressive countries in promoting R&D. Over the past 2 decades, Canada has provided a specturm of tax incentives and direct financial assistance. It appears that Canadian R&D expenditures have not responded robustly to the incentives. The proportion of GNP devoted to R&D has increased only slightly and contines to be less than half that of the United States.

The premise of the incentives in S. 700, S. 1003, and S. 1065 is that export performance is closely related to levels of R&D spending. In this connection, I would note that while the United States does, in fact, have a trade surplus in "technology intensive" manufactured products and a trade deficit in "nontechnology intensive" manufactured products, one should be cautious, in concluding that trade surpluses are the result of high levels of R&D spending. For example, R&D may be performed in the U.S. while the production embodying that R&D may occur elsewhere. Also, because of the long lag between R&D and the intorduction of new products, the impact, if any, of R&D on trade is difficult to estimate. More likely, a strong trade performance depends on a sound economy overall, including a strong world economy, rather than any one factor as specific as R&D spending.

PROPOSALS FOR RESEARCH AND DEVELOPMENT INCENTIVES

The specific tax incentives being considered by this Committee would raise a number of difficult administrative and definitional issues. Moreover, the increment to R&D effort that they might produce would be small relative to the size of subsidy provided. Most of the budget cost would be used to regard activities that would have occurred without the incentive. These proposals would also add substantive administrative complexity. Let me now discuss each of the bills, in turn.

S. 700 calls for a 10 percent investment tax credit for R&D expenditures. Eligible expenditures are defined in the bill by reference to section 174. However, this section, in fact, serves exactly the opposite purpose. Its effect, as I pointed out

[1] However, when R&D expenditures on defense and space are subtracted from these total R&D figures, the U.S. ranks behind Germany and Japan in civil R&D expenditures.

earlier, is specifically to avoid the need to define costs allocable to "research and development" in most cases. A taxpayer is not obliged to identify the expenses that are allocable to R&D since they may be currently deducted whether properly allocable to R&D or to activities generating current income. Under the proposed tax credit, the aforementioned problems of identifying costs allocable to research and development would be introduced.

S. 1065 would provide a 25 percent tax credit for qualifying corporate grants to colleges and universities earmarked for basic research. This would require the formulation of an administrable definition of basic research. Even if this were possible, there is probably no way to assure that the earmarking of such funds would actually increase basic research expenditures. Since basic research is a major ongoing function of colleges and universities, existing nonearmarked funds could readily be shifted to other competing educational programs.

We strongly support the idea of more money for college and university research but the direct expenditure alternative may be more efficient. Agencies familiar with research activities, such as the National Science Foundation or the Commerce Department, would have more expertise in identifying basic research than would the Internal Revenue Service. They might also be better able to require increased effort as a condition for grants. A direct expenditure program also offers the attraction of being subject to the rigors of the normal budget appropriation process. It is also subject to Administration and Congressional review and oversight.

TAX MEASURES TO STIMULATE CAPITAL FORMATION

The Administration has stressed repeatedly the importance of business investment in advancing our economic objectives. An increase in the rate of U.S. investment spending can be expected to improve our international competitive position. It could also increase domestic productivity and thus the growth rate of real incomes, and it could help slow inflation.

However, if we seek to promote investment through a special tax program, the offsetting revenue cost must be weighed in the balance. To realize the desired economic objectives, any such tax program must be consistent with continued improvement in the budget position. The goal of a balanced budget in fiscal 1981, which is itself important for business confidence and encouragement of private saving, is in direct competition with any substantial additional business tax reduction for 1981.

Even if you believe that budget balance must be postponed to allow additional tax reduction, we must also weigh the competing claims of individual taxpayers for income and payroll tax relief against the benefits of business tax reductions. In this regard, we should remember that the share of tax reduction in the 1978 Act devoted to capital formation was very large by historical standards. Nearly half of the net tax cut produced by that Act was devoted to measures that increase the returns to capital investment. These include the capital gains and minimum tax reductions, the corporate rate reductions, liberalization of the investment credit, the portion of the individual rate reductions applying to property income, and a number of small business tax provisions.

The economy is now early in the process of reacting to the large reductions in business taxes provided in the 1978 Act. Recent experience continues to confirm, as economic research has repeatedly indicated, that tax incentives for investment act with a long time lag. This fact does not diminish their importance, but it does mean that we should perhaps take a longer perspective in the planning of additional investment incentives and expect to stay with the choices for some time. It is, however, not premature to be studying the alternatives now and to consider the long term as well as short-term budget consequences of each.

ALTERNATIVE WAYS TO STIMULATE CAPITAL FORMATION

I believe that it is useful to distinguish two classes of tax policy to encourage investment. The first involves general tax reduction on the rewards from owning and employing capital. These would include corporate and individual rate reductions, reduction or elimination of the double tax on corporate dividends, and more favorable treatment of household saving. This general approach often has the advantage of neutrality—that is, it is less likely to favor certain kinds of physical plant and equipment over others, or to favor particular industries over others. The other general approach to investment incentives would tie tax reduction directly to capital put in place. This type of policy is often perceived as having a quicker effect than rate reductions or saving incentives, although it may not have any larger eventual impact for an equivalent amount of annual revenue cost.

Both bills, S. 231 and S. 395, which are before us for discussion today are incentives of this second type. Either means of accelerating depreciation allowances ties the value of tax forgiveness or deferral for any company to the amount of investment put in place within a given year. Because these bills are the immediate subject of our attention here, I will concentrate my remarks on investment incentives of this general type. This does not imply a preference for this type as compared to rate reduction, corporate integration, or saving relief. These more general approaches should also be included in any full evaluation of tax options to promote investment.

As a practical matter, a decision to tie tax reduction directly to annual investment expenditure probably means either increasing the investment credit or speeding up depreciation allowances. I have recently presented by views on the investment tax credit in testimony before the Subcommittee on Oversight of the House Ways and Means Committee. Let me just repeat some of the major conclusions here. First, the investment credit stimulates investment in qualifed property by reducing the cost of acquiring and using it. The credit is analogous to cash grants. Second, the investment credit was just expanded significantly in the Revenue Act of 1978. In particular, this expansion eliminates a reduction in the credit rate, generally from 10 to 7 percent, that had been scheduled for 1981 and allows a much larger proportion of the credit earned by investment in any given year to be claimed by the taxpayer in that same year. The result is to make the credit more certain—a major factor in effectiveness of any investment incentive. On the other hand, in spite of some liberalization in the 1978 Act, the credit is still mainly restricted to investment in machinery and equipment. And, because of a number of structural problems, its impact is strongest for those assets having a useful life of 7 years. Industrial structures and very short-lived machinery and equipment are left unsubsidized by the investment credit. Third, to increase the rate of the investment credit without further structural reform would tend to magnify these defects and to increase once again the proportion of the credit that must be carried forward. Structural reform would be contentious and expensive. It is perhaps for these reasons that legislative interest seems recently to have moved from expansion of the investment credit toward liberalization of depreciation allowances as a direct investment incentive.

Accelerated depreciation reduces the cost of employing capital goods in essentially the same way as expanding the investment credit. Each may be thought of as a bonus for installing additional capacity or replacing and modernizing existing capacity. The investment credit is like a series of cash grants for initial purchase and replacement of equipment, while accelerated depreciation is more analogous to a series of interest-free loans. Of course, the amount of these interest-free loans may be set so as to have the same equivalent cash value as any given increase in the investment credit.

However, accelerating depreciation and increasing the investment credit have different implications for the Federal budget. Much of the revenue loss associated with accelerating depreciation is postponed to later years, it appears to have a larger "bang for the buck" at the time of enactment. Such appearances may be dangerous to long-term budget planning. Five year revene cost projections for the specific proposals under discussions are given in Table 2. These costs rise very steeply over this period.

Before discussing the two depreciation proposals being considered at this hearing, it may be helpful to review briefly the current law in this area.

Current law regarding depreciation.—In computing taxable income, a taxpayer is permitted a deduction for the depreciation of assets used for business or investment purposes. The imputed annual decline of asset value is regarded as a cost of doing business, similar to expenditures for utilities, wages, and maintenance. Depreciation can now be computed in one of two ways: (i) by reference to the "facts and circumstances" surrounding each item of depreciable property, or (ii) by using the asset depreciation range and class life (ADR) system.

TABLE 2—REVENUE COST OF SENATE BILLS S. 231, S. 935, S. 700, S. 1003, AND S. 1065 TO BE EXAMINED BY THE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT AS PART OF HEARINGS ON TAX INCENTIVES FOR EXPORTS

[In millions of dollars]

	Calendar years				
	1980	1981	1982	1983	1984
S. 231:					
Expand ADR from 20 percent to 30 percent and simplify small business depreciation [1]	1,248	1,802	2,332	2,897	3,385
S. 935:					
5-year depreciation for equipment, with 2 years for pollution control facilities.	2,682	6,531	8,383	9,684	10,721
S. 700:					
10 percent investment tax credit for research and development expenditures	1,872	2,227	2,516	2,767	2,999
S. 1003:					
Amend bad debt and research and development provisions and provide for annual realization of foreign currency losses	121	123	134	41	49
S. 1065:					
Credit for contributions by corporations to basic research	40	25	25	30	35

[1] In addition, calendar year 1979 liabilities are reduced by $475 million.

Office of the Secetary of the Treasury, Office of Tax Analysis—June 15, 1979.

Under the facts and circumstances method, a taxpayer must estimate the useful life and salvage value of each asset. Asset cost less salvage value represents the total amount to be depreciated, and useful life measures the period of depreciation. Annual deductions are then computed by a depeciation method that assumes a ratable decline in value (straight-line depreciation) or a disproportionately large decline in the early years (accelerated depreciation such as "declining balance" or "sum-of-the-years digits"). Depreciation of individual assets through facts and circumstances estimation is usually speculative and time consuming. The determination is a source of frequent controversies between IRS agents and taxpayers.

The ADR system was adopted by Treasury and ratified by Congress in 1971. Under ADR, there are over 100 guideline class lives for assets, based either upon the activity in which the assets are used (*e.g.*, mining or agriculture) or the type of asset involved (*e.g.*, automobiles or office furniture). The classes and lives are those established by Treasury under 1962 guidelines, with some modifications resulting from Treasury's examination of data collected since 1971.

Each year a taxpayer may elect whether or not to use ADR for the assets placed in service that year. If ADR is elected, the taxpayer establishes for each asset a separate account containing only the property acquired that year (a "vintage account"). As an example, a typical manufacturer of electronic products would establish a vintage account for its office furniture acquired in 1978, another account for its typewriters, an account for its automobiles, an account for its light trucks, and another account for the remainder of its assets. New vintage accounts are established for acquisitions in subsequent years.

Assets grouped in the vintage accounts are depreciated under special ADR rules, adopted in 1971 for the purpose of encouraging investment in equipment. Treasury has generally established a guideline life for each asset class that is shorter than the actual useful lives of 70 percent of all assets in that class. A taxpayer may then choose a depreciation allowance that lies within a range from 20 percent below to 20 percent above the prescribed class life, wihout regard to that taxpayer's particular facts and circumstances. For instance, the electronics manufacturer could use any life form 3 to 5 years for its light trucks and any life from 8 to 12 years for its office

furniture. The result can be substantial tax savings as compared to determination by facts and circumstances. ADR permits many businesses to recover their equipment costs over a time period about one-half as long as would be warranted under facts and circumstances.

Proposed depreciation changes.—S. 231 would allow the taxpayer electing the ADR depreciation system to reduce the depreciation period by 30 percent below the guideline life, instead of 20 percent as in present law. This bill also prescribes a set of shorter lives that may be taken on a straight line method by smaller businesses having $250,000 or less of assets other than real estate. S. 493 represents a much different approach to depreciation allowances. This bill would allow taxpayers to write off all assets now eligible for the investment credit over a 5-year period, and to write off all pollution control devices over a 2-year period. I would like briefly to compare the general approaches of these 2 approaches without treating the specifics in any detail.

S. 231 recognizes the current problems many small businesses encounter in dealing with ADR. Only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in 1974 (the latest year for which data are available). By contrast, ADR was elected in that year by over 90 percent of corporate taxpayers with depreciable assets of $1 billion or more. Undoubtedly, some taxpayers illegitimately use the short lives permitted under ADR without formally electing the system and complying with the accounting and reporting requirement. But for many small businesses, the perceived complexity of the ADR system has discouraged its use and led to a loss of tax benefits available to larger taxpayers.

Under S. 231, small businesses could use simple straightline depreciation and still obtain the tax savings otherwise available under accelerated depreciation methods. The permissible depreciation lives for small businesses would be shortened below the shortest lives allowed under ADR, so that the present value of depreciation deductions would be identical under the two systems. However, the special shortening of lives would not be counted against the taxpayer in determining eligibility for the investment tax credit.

Unlike some other proposals for "small business" benefits, this bill would not give small businesses greater tax benefits than those available to other firms. Rather, equivalent benefits would be provided in a form that makes fewer demands on taxpayer recordkeeping. As a result, this proposal should avoid the tax sheltering problems associated with provisions that target special relief to taxpayers who satisfy prescribed eligibility criteria.

An alternative for small businesses is to make ADR election attractive by drastically simplifying the reporting requirements and, perhaps, consolidating certain classes. With more universal coverage of the ADR system, an expansion of the ADR range would have the advantages of continuing an existing, and now familiar, system and providing relatively even-handed relief among companies that have capital of varying durabilities.

S. 935 also offers several tax simplification advantages. Replacing the present system of depreciation allowances with a system having a single cost recovery period, or a small number of such periods, offers administrative simplicity as well as substantial tax reduction for most businesses. There would be no distinction between electors and nonelectors, no need to review and monitor guideline periods, and very simple accounting rules. For these reasons, these proposals deserve very careful study.

However, there are potentially serious drawbacks connected with the system prescribed in S. 935. Any proposal that reduces the number of asset classes from over 100 (under ADR) to 2 or 3 will create tax benefits that are disproportionate among various industries. In the case of S. 935, those companies having relatively long-lived machinery and equipment would certainly enjoy the largest relative advantage. As a result, partnership interests in long-lived productive assets would become most attractive to high bracket taxpayers as tax shelters. Provisions to limit shelters and turnover of ownership might negate many of the potential benefits of simplification.

Instituting a cost recovery system that has 2 or 3 broad classes would either have a very high revenue cost or result in no tax reduction for companies having mainly short-lived assets. In particular S. 935 would also provide no parallel reductions for expenditures on plant and other structures. This would reinforce the tendency of the investment credit to attract capital away from structures toward machinery and equipment. Such proposals will also generally weaken the investment credit since most depreciation periods are reduced below 7 years. Consideration of such proposals should, therefore, be accompanied by reconsideration of the structure of the investment credit.

In sum, a few general observations can be offered. Expansion of the ADR range is the approach to direct investment incentives that requires a less radical departure from present law and current business practice while a simplified capital recovery system offers administrative advantages that cannot be attained under ADR. Revenue cost is a formidable obstacle to immediate enactment of substantial tax cuts along the lines proposed by either S. 231 and S. 493. But, with an awareness of the budgetary constraints we face, we should carefully study these and other programs, including more general tax reductions for business income, to develop a solid and long-lasting tax basis for capital expansion.

Senator BYRD. The next witness is Mr. Mark Shepherd, Jr., chairman and chief executive officer of Texas Instruments, Inc. We are glad to have you, Mr. Shepherd.

Mr. SHEPHERD. Thank you, sir. I am glad to be here.

Senator BENTSEN. I would like to attest that this is one of the very most distinguished business leaders of America. He and his associates in their company, have done an outstanding job on research and development and technology and remaining competitive in a really tough, competitive trade world today.

Senator BYRD. You may proceed.

STATEMENT OF MARK SHEPHERD, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, TEXAS INSTRUMENTS, INC.

Mr. SHEPHERD. Thank you.

Mr. Chairman and members of the subcommittee, I would like to summarize my testimony for you and respond to any questions you have. The full text of my statement will be submitted for inclusion in the record.

Senator BYRD. It will be included in the record.

Mr. SHEPHERD. We, at Texas Instruments, have been enthusiastic supporters of efforts, such as those under consideration today, to provide investment incentives for business, to boost productivity and to stimulate research and development. Legislation such as that formulated by Senator Bentsen and others is critically needed to revitalize economic growth.

Texas Instruments has recently sponsored a study on tax credits for R. & D. spending. Today, in view of time constraints, I would like to focus my discussion on those tax incentives that relate, in particular, to Senate bill 700, introduced by Senator Danforth.

S. 700 recognizes the relationship between research and development and exports. Increasing R. & D. expenditures is one way to stimulate exports but other ways should be, and are being, considered by this subcommittee.

To demonstrate the need for stimulation we must first examine the reasons for our export problem.

The size of that problem has been described earlier by the chairman.

It is easy to place the blame for the imbalance on our trading partners and some of it belongs there. But even if they did everything we could ask, we still would suffer a massive deficit. Our basic problems are right here at home, and they are easy to identify:

High rates of inflation.

A low rate of productivity improvement.

Lack of an aggressive export policy and lack of an effective energy policy.

A successful anti-inflation program is a necessary prerequisite for a meaningful export program.

Inflation can be brought under control. But to accomplish that goal without serious disruptions of employment and output requires a gradual unwinding, over many years, of inflationary expectations.

To stabilize prices in the long run, we should put a ceiling on Federal Government spending as a percentage of GNP and require balanced budgets on a rolling 3- to 5-year basis.

Wide fluctuations in the growth of the money stock must be avoided. We should gradually bring the growth of the money stock down to a steady rate about equal to the long-term average real growth of GNP.

Our Government must provide the proper environment for growth and profitability by redirecting tax policy to encourage more investment and less consumption. A blueprint for basic tax reform should include the elimination of double taxation of dividends, still lower tax rates on capital gains, higher investment tax credits, accelerated depreciation of equipment and facilities and the introduction of tax credits for R. & D. spending and exports.

And we must strive continuously to make industry and government at all levels aware that productivity gains are absolutely essential to our efforts to remain competitive in the world marketplace, as well as to reduce inflationary pressures at home.

Tax credits for R. & D. spending. Gains in productivity follow increases in capital investment. However, in order to obtain step-function increases in productivity, the accumulation of capital must be accompanied by more research and development.

Edward Denison, at the Brookings Institution, and others have reached the remarkable conclusions that about one-half of the U.S. increases in productivity can be attributed to advances in technological/managerial knowledge—and some residual sources.

By contrast, only 15 percent is attributable to capital usage. This does not diminish the importance of capital outlays. They create the new capacity essential to a growing economy, and it is through new equipment and facilities that more advanced technology is injected into the production and distribution streams of the economy. Denison's studies do imply, however, that the impact on productivity of a dollar spent on R. & D. is several times greater than that of a dollar invested in conventional fixed capital.

It is those countries with higher rates of growth in R. & D. expenditures that also have higher productivity gains. In Japan, annual increases in R. & D. spending close to 18 percent have contributed to yearly productivity improvements of about 8 percent.

Conversely, the United States with an R. & D. growth rate of 6.8 percent has experienced the lowest productivity improvements among the major industrialized countries.

Nearly every measure demonstrates that the level of capital formation and the pace of R. & D. activity have slowed markedly in recent years. Total industrial R. & D. spending in constant dollars has declined sharply from 2.15 percent of GNP in 1963 to less than 1.6 percent in 1977. If these trends continue, the United

States will lose its standing as one of the world's most innovative countries and one of the largest exporters of high-technology goods.

It follows that, if the United States intends to remain competitive, Congress and the administration should examine seriously a tax credit for research and development expenditures similar to the investment tax credit.

Texas Instruments has sponsored a study that brings into focus the effects of a tax credit on R. & D. spending. The results of the analysis, prepared by Andrew Brimmer in cooperation with Data Resources, Inc., demonstrate the positive impact of a tax credit on R. & D. spending, productivity and inflation.

For example, 25 percent tax credit on R. & D. spending starting in 1966 would have added 0.2 percentage points to annual productivity gains during 1966–77, 0.3 percentage points per year in 1978–87 and 0.4 percentage points per year in 1988–97.

To put these numbers in perspective, we only need to recall that the total productivity increase in 1978 was 0.4 percent.

The annual boosts to productivity of a 25-percent tax credit would have reduced the consumer price index by 0.1 percentage points per year during the first decade, 0.4 percentage points per year in the second decade, and 0.6 percentage points per year in the third decade.

The study also examined the impact of tax credits of 10 percent and 50 percent. The comparison indicates that the results are not linear but exhibit larger than proportionate gains. For example, in the period 1988-97 when we double the tax credit from 25 percent to 50 percent, the R. & D. outlays increase by a factor of 3.5.

An interesting byproduct of the analysis reveals the beneficial impact on exports of increased R. & D. spending. At first the impact is small but it grows progressively larger through time. For instance, a 50-percent R. & D. tax credit would add $26.58 per year to real exports during 1988–97. This represents a 12-percent increase over the projected volume of exports during that time frame.

We estimate that the net revenue loss of a 25-percent R. & D. tax credit program would average $2.3 billion annually for the first 10 years. However, in subsequent time perods, the cumulative impact of R. & D. begins to pay large dividends. Faster economic growth produces larger tax gains and the net impact becomes a positive $6.1 billion per year in the second decade, more than offsetting the losses in the previous period.

This result, together with the larger gains to be realized in future years, indicates that the R. & D. tax credit yields positive returns to society as well as to private firms.

More R. & D. spending and higher productivity gains will improve the environment for exports, but this is still not enough. The U.S. share of the world export market is in a serious long-term decline dropping from 18 percent in 1960 to 11.8 percent in 1977.

The U.S. export policy must have as its objective to end this loss of market share and increase exports sufficiently to bring about equilibrium in our trade balance.

To reach that objective, we must move on two fronts: the elimination of disincentives to export generated by Government regulations and the creation of incentives to export.

We need to jar our economy into awareness of the national need to export. We must have dramatic incentives for all U.S. businesses to export and we must put money in the exporters' pockets now in response to good performance.

Among many proposals for financial incentives, we feel the most effective would be based on a change in the investment tax credit. This approach would permit a credit of up to 15 percent of investment in qualified assets for firms that increase their exports by up to 25 percent above a base period.

The impact of this change would be to stimulate investment and exports—both highly beneficial to the U.S. economy.

This proposal is just a starting point. Further studies will be needed to ascertain the exact parameters that provide an optimal solution.

As current models appear unable to provide specific answers to this problem, we used the DRI model to stimulate the economic consequences of a similar tax scheme.

The simulations performed by DRI illustrate the impact of a 5-percent tax credit on exports under two alternative assumptions:

The first simulation assumes that two-thirds of the export tax credit is given to business in the form of a credit on business equipment and one-third is passed on in reductions of export prices. Real investment would increase by $8.4 billion per year—roughly 5 percent per year—over the baseline forecast while the volume of exports would rise by $2.2 billion—about 2 percent per year.

The second simulation assumes that two-thirds of the export tax credit is translated into lower export prices and one-third is retained in the form of an investment tax credit. Both exports and investment would increase by 3 percent per year over the baseline forecast.

The tax credits on R. & D. and exports described this morning are ideal complements. We are unable to show their cumulative impact because the simulations were conducted over different time periods but it is certain that the combination of such credits would provide a strong boost to our economy.

Finally, to further improve our trade balance, we should encourage domestic energy production by quickly removing all price controls and by implementing the other measures described in the full text of my testimony.

The challenge is to achieve, as a nation, the discipline and innovation required to reverse the decline of the U.S. position in world trade. To accomplish this will take a coordinated effort by U.S. industry and U.S. Government at all levels.

The stakes are high. The future health of the U.S. economy—vital to continued gains in our living standards and to our ability for self-defense—depends in large measure on our success.

Thank you.

Senator BYRD. Thank you, Mr. Shepherd.

I have just one question, and then I will yield to Senator Bentsen.

How do you view the importance of depreciation in encouraging American productivity?

Mr. SHEPHERD. I think that depreciation is an important aspect of the problem of capital formation. It lets us get our money back faster, making cash available for the growth of our businesses.

I do think, if I might add, sir, that one of the problems we incur when we talk about tax reform is that we take but one piece at a time. We need to conduct many studies and many simulations to optimize the mix of the tax items we choose to use, for maximizing the growth of our economy and the growth of exports. I think increased depreciation is important.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. In this intensely competitive world, of all the major countries, we are the only one who really does not have a major export policy and we are the only one where business and Government appear as adversaries. The Webb-Pomerene Act, for example. It has not followed its original objective and has made it very difficult to form a consortia of companies when it comes to export trade.

Do you have any particular suggestions in what can be done insofar as positive and aggressive trade policy for this country?

Mr. SHEPHERD. The Webb-Pomerene Act is not specifically applicable to the type of business that my company engages in. It would be more applicable to people with very large construction projects such as refineries.

Senator BENTSEN. I am not referring to just that act. I am talking about the overall export policy, what can be done.

Mr. SHEPHERD. As I stated in the testimony, we need to eliminate as many nitpicking disincentives as possible. We need to provide some mechanism for generating a reward for people who do a good export job.

Our manufacturers have been comfortable with our large domestic market in the past. We have not had to export to live. Because of our oil bill—and it is going to get bigger, not smaller—we now have to export to live. We have to provide the incentives necessary to get our people involved in exporting.

I think another important factor that many of our companies do not recognize, and the Japanese recognize this very well, is that in the process of serving a world market, you generate larger volumes and lower costs and you are more competitive than when just serving a national market.

Senator BENTSEN. Mr. Shepherd, on the annual report of the Joint Economic Committee, for the first time in 20 years, we had all the members sign that report and there was a substantial change in economic philosophy, in talking about concentrating on the supply side rather than the consumption side of the economy.

Would you think that was appropriate?

Mr. SHEPHERD. Yes, sir.

Senator BENTSEN. What we are talking about is trying to increase productivity in the country. Insofar as you refer to nitpicking rulings, when we get to the question of R. & D., as it is now being treated, some of the regulations and rulings, is there a danger that we will be exporting some of our R. & D. to subsidiary plants in other countries?

Mr. SHEPHERD. I think that yes, we will use our research and development in plants that we own in other countries. I do not think that is a great danger.

I think the great danger is in selling your R. & D. to a third party with no strings attached. You just sell it for cash, and that is that.

In my company, we have a policy of insisting on 100-percent ownership of subsidiaries in other countries. If we cannot get 100-percent ownership, we do not go.

Senator BENTSEN. The point you were talking about on trade, in spite of the previous testimony about trade improving, the Commerce Department says the long-term prospects are that we could have a $40 billion deficit in the next decade. So it is a matter of continued concern.

Another point you make, too, that it takes awhile for these things to turn around. Too often we look to quick fixes in this country, something that will take care of the next election. We are going to have to pursue much more substantive and long-term policies.

Thank you.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. On page 17 of your abbreviated statement, you referred to energy. You said we should encourage domestic energy production by quickly removing all price controls, with which I agree, and by implementing the other measures described in the full text of my testimony.

I have read the rest of it, and I cannot find what specifically you are referring to as it relates to energy.

Mr. SHEPHERD. Great emphasis must be placed on the use of coal in the United States, page 15 of the full testimony. I will not bother to read it.

Senator PACKWOOD. Go ahead and tell us what we should do.

Mr. SHEPHERD. What we ought to do is to exert every effort to develop all of the hydrocarbons remaining in this country—I personally think there are quite a few.

We are not going to find very many, if any, of the very large reservoirs, but the distribution of reservoir size, as one might expect, is many small reservoirs and large ones. We need to make the moneys available for the people who do that exploration to find them.

The United States is the most intensively explored piece of real estate in the world and we should not handcuff our domestic oil companies in their efforts to look elsewhere in the world.

We must do something about getting on and using the huge resources of coal. That may require compromises in the environmental area.

I think nuclear energy has to play a greater role in the future of not only this country but all countries, in spite of the current flap due to Three Mile Island and then we can start thinking about the exotics. We can think about solar. We can start thinking about the tidal basins and all the other plans that you hear about.

Senator PACKWOOD. Do we need to give any additional incentives for the production of domestic energy beyond decontrol of prices generally?

Mr. SHEPHERD. I think that decontrol would provide adequate incentive at the moment.

Senator PACKWOOD. We would not need any per barrel incentives for shale oil or developmental credits for coal gasification or coal liquefaction?

Mr. SHEPHERD. Let me state that I am not an energy expert, but I think that if we decontrol and if OPEC continues to raise its prices at a rate that I think they are going to continue to raise them, we will rapidly reach the point where the world price per Btu makes coal and gassification of coal, coal liquification of, and shale oil competitive on a Btu basis.

Senator PACKWOOD. This is just a procedural question. I am sufficiently interested in this topic. I will read all the statements, but when you make reference to page 15, are you talking about something called the strategic planning conference?

Mr. SHEPHERD. No.

Senator PACKWOOD. I do not have your full statement.

Mr. SHEPHERD. There is another statement, labeled "Statement of Mark Shepherd before the Finance Committee" and so on.

Senator PACKWOOD. Thank you very much. I did not have it before.

I have no other questions.

Senator BYRD. Senator Danforth?

Senator DANFORTH. Mr. Shepherd what, in your opinion, is the economic future of our country unless we provide greater incentives for advances in research and development and new technology? Where are we heading?

Mr. SHEPHERD. We are going to rapidly catch up with the United Kingdom.

Senator DANFORTH. It seems to me that the problem with the administration's economic policy, if you can call it an economic policy, is that it really offers no future for this country. It is simply an effort to try to balance the budget largely by allowing tax revenues to catch up with spending, that is, through the factor of inflation pushing up tax revenues. But there is nothing meaningful with respect to the so-called supply side of the economy that Senator Bentsen was referring to.

In fact, we are going in the opposite direction.

Between 1964 and 1977, R. & D. spending in America as a percentage of GNP declined 26 percent; in Japan it increased 58 percent; in Germany, it increased 64 percent. Even in France, it increased 13 percent.

We are going in the opposite direction. We are not moving ahead.

When you talk about nonmilitary R. & D., our performance is even worse. We are behind Japan, we are behind Germany in nonmilitary R. & D. as a percentage of gross national product.

So the theory behind the Senate bill 700 is to provide some hope for the future of this country.

Do you have any further comments along those lines?

Mr. SHEPHERD. I think that the R. & D. problem is even deeper than you have stated.

If you omit military and space spending, we are down to the $21 or $22 billion level in the United States, and the Japanese—this is

for 1977—are up to $14 billion. So they are rapidly closing the gap in absolute dollars.

That is big trouble for us.

Senator DANFORTH. Senate bill 1065—I do not know if you are familiar with that or not—that would provide a 25-percent tax credit for additional corporate contributions to colleges and universities for basic research. The theory behind that is as follows:

First of all, there should be diverse sources of basic research funds for colleges and universities. It should not solely be a matter of going to Uncle Sam and getting funds from the Federal Government to do research on the university campus. There should be other possible source of funds, so that it would be beneficial to bring the business community into a closer relationship with colleges and universities to develop a greater sense of community between the two. There would be a very small projected revenue loss from doing this. About $18 million in 1980 is the projected revenue loss from this bill, which is really not very much at all. And that basic research as opposed to applied research is a fundamental need in America from which future growth stems.

That is the theory behind that particular bill. Do you have any thoughts on it?

Mr. SHEPHERD. I think that it is a good mechanism. You may not be shooting quite high enough, in my opinion, because we are short of basic research and not too much real, basic research is performed in industry. We in industry are similar to politicians. We have to make a bottom line number every year, just as you have to get reelected every so often, so most of the basic research would be done in the universities.

I do not have any numbers in mind, but there is considerable support presently supplied by industry to universities for unrestricted research.

Senator DANFORTH. I am told by business people that I know that while they can get a deduction for up to 5 percent of their profits contributed to not-for-profit organizations, the more typical figure is 1 percent.

The effort here is to try to encourage an increase in what businesses are doing for colleges and universities, particularly in the area of basic research.

Mr. SHEPHERD. Yes.

Senator BYRD. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

Mr. Shepherd, there are economists who argue that the investment tax credit and accelerated depreciation rates are basically subsidies for corporate expenditures that would be made in any event. Could you comment on that argument, and would those investments be made anyway, or would the economy simply go without?

Mr. SHEPHERD. They improve the cash flow so that you do have the money to make investments. If you do not have that money, you have to go borrow it, or not make them.

There is some limit to how much you can borrow.

I do not think they are subsidies for investments that would be made anyway. Obviously there would be some of that, but a relatively small percentage.

Senator WALLOP. When the administration contends that business may well prefer a tax reduction related to capital formation as opposed to R. & D., at the moment, what would be the posture of your company?

Mr. SHEPHERD. Well, I do not know whether you noticed or not, but as I went through my so-called blueprint for tax reform, I did not include a corporate tax rate reduction, and that is very deliberate.

A corporate tax rate reduction does two things. It locks in some money where it already is and second, corporate tax rates going down are dissipated in a relatively short period of time and prices decrease to the consumer. That is good for inflation, but that is still just tilting toward consumption and away from investment. It does not tilt you toward investment.

Senator WALLOP. Ultimately, tilting more toward consumption is inflationary in the long run anyway, is it not?

Mr. SHEPHERD. Yes, I think so.

Senator WALLOP. I have no further questions.

Senator BYRD. Thank you, Senator Wallop.

If there are no additional questions, thank you very much, Mr. Shepherd. You made a fine presentation.

[The prepared statement of Mr. Shepherd follows:]

STATEMENT OF

MARK SHEPHERD, JR.
CHAIRMAN & CHIEF EXECUTIVE OFFICER
TEXAS INSTRUMENTS INCORPORATED

BEFORE THE

UNITED STATES SENATE
SENATE FINANCE COMMITTEE'S
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

WASHINGTON, D.C.

June 18, 1979

49-059 O - 79 - 5

A MEANINGFUL EXPORT POLICY

Mr. Chairman and members of the Subcommittee, I am Mark Shepherd, Jr., Chairman of the Board and Chief Executive Officer of Texas Instruments Incorporated. We, at Texas Instruments, have been enthusiastic supporters of efforts, such as those under consideration today, to provide investment incentives for business, to boost productivity and to stimulate research and development. Legislation such as that formulated by Senator Bentsen and others, is critically needed to re-vitalize economic growth.

Texas Instruments has recently sponsored a study on tax credits for R&D spending. In view of time constraints, today I would like to focus my discussion on those tax incentives that relate, in particular, to Senate Bill 700, introduced by Senator Danforth. S.700 recognizes the relationship between research and development and exports. Increasing R&D expenditures is <u>one</u> way to stimulate exports but other ways should be and are being considered by this Subcommittee.

To demonstrate the need for stimulation we must first examine the reasons for our export problem.

In 1978, the U.S. suffered a negative trade balance of $34.1 billion. Although moderating somewhat, the trade deficit will remain between $20-30 billion this year.

It is easy to place the blame for the U.S. imbalance on our trading partners and some of it belongs there. But even if they did everything we could ask, we still would suffer a massive deficit. Our basic problems are right here at home, and they are easy to identify:

- high rates of inflation
- a low rate of productivity improvement
- lack of an aggressive export policy, and
- lack of an effective energy policy

MEASURES TO CONTROL INFLATION

A successful anti-inflation program is a necessary prerequisite for a meaningful export program. The rise in consumer prices for 1978 was nearly 8%, and inflation has continued to accelerate, from a rate of 8.8% in the third quarter of 1978 to 9.1% in the fourth and to 11.1% in the first quarter of 1979.

Inflation can be brought under control. But to accomplish that goal without serious disruptions of employment and output requires a gradual unwinding of inflationary expectations. It is a long-term process, requiring patience by all and the resolute maintenance of a course to that end by the Federal Government.

- To stabilize prices in the long run, we should put a ceiling on Federal Government spending as a percentage of GNP and require balanced budgets on a rolling three-to-five-year basis.

- Wide fluctuations in the growth of the money stock must be avoided. We should gradually bring the growth of the money stock down to a steady rate about equal to the long-term average real growth of GNP.

- Our government must provide the proper environment for growth and profitability by redirecting tax policy to encourage more investment and less consumption. Interest paid is tax deductible, interest earned is taxed and usually at the highest applicable marginal rate. A blueprint for basic tax reform should include the elimination of double taxation of dividends, still lower tax rates on capital gains, higher investment

tax credits, accelerated depreciation of equipment and facilities and the introduction of tax credits for R&D spending and exports.

And we must strive continuously to make industry and government at all levels aware that productivity gains are absolutely essential to our efforts to remain competitive in the world marketplace, as well as to reduce inflationary pressures at home.

TAX CREDITS FOR R&D SPENDING

Despite recent problems, the U.S. still maintains a formidable international competitive position. We have abundant natural resources, an exceptional food-producing capability and absolute unit labor costs that last year were still 20% lower than Germany's and 25% lower than Japan's (see attachment 1).

The U.S. advantage is based on the accumulation of a large stock of productivity gains between 1870 and 1950. But in order to maintain this margin, the U.S. economy will have to reverse the dismal productivity performance of this decade. In 1950, one American produced as much as seven

Japanese or three Germans. Those ratios are now down to 2:1 for Japan and 1.3:1 for Germany. Current estimates are that Germany will outproduce us by 1985.

Sources of U.S. productivity problems often cited are a decline in the work ethic, lack of worker motivation and general moral decay. Undoubtedly, there is something to such concerns. But changed worker attitudes cannot explain the dramatic deceleration in annual productivity growth from about 3% in the 1950s and 1960s to less than 1% in the mid-1970s. One must search elsewhere for the major reasons for poor productivity performance.

Findings by Edward Denison, at the Brookings Institution and John Kendrick, of George Washington University, indicate that the U.S. drop in productivity growth has been caused primarily by slowdowns in the rate of technological progress, the proliferation of government regulation and the low level of investment.

Gains in productivity follow increases in capital investment (see attachment 2). However, in order to obtain step-function increases in productivity, the accumulation of capital in the form of facilities and equipment must be accompanied by more research and development to increase the effectiveness of capital investment, generating more efficient manufacturing processes and creating new products.

Professor Solow, at the Massachusetts Institute of Technology, has reached the conclusion that, "more than half of the increase in productivity is a residual that seems to be attributable to technical change; to scientific and engineering advance, to industrial improvement and to knowhow of management methods." Edward Denison has reached similar conclusions. According to his findings, about one half of the U.S. increases in productivity can be attributed to advances in technological/managerial knowledge and some residual sources. By contrast, only 15% is attributable to capital usage (see attachment 3).

This does not diminish the importance of capital outlays. They create the new capacity essential to a growing economy, and it is through new equipment and facilities that more advanced technology is injected into the production and distribution streams of the economy. Denison's studies do imply, however, that the impact on productivity of a dollar spent for R&D is several times greater than that of a dollar invested in conventional fixed capital. It is those countries with higher rates of growth in R&D expenditures that also have higher productivity gains. In Japan, annual increases in R&D spending close to 18% have contributed to yearly productivity improvements of about 8%. Conversely, the U.S., with an R&D growth rate of 6.8%, has experienced the lowest productivity improvements among the major industrialized countries (see attachment 4).

The flow of inventions and the translation of discoveries into commercially feasible innovations have by no means ceased in this country. Yet, nearly every measure demonstrates that the level of capital formation and the pace of R&D activity have slowed markedly in recent years. Total industrial R&D spending in constant dollars has declined sharply from 2.15% of GNP in 1963 to less than 1.6% in 1977 (see attachment 5). If these trends continue, the U.S. will lose its standing as one of the world's most innovative countries and one of the largest exporters of high-technology goods.

It follows that, if the U.S. intends to remain competitive, Congress and the Administration should examine seriously a tax credit for research and development expenditures similar to the investment tax credit.

Texas Instruments has sponsored a study that brings into focus the effects of a tax credit on R&D spending. The results of the analysis, prepared by Andrew Brimmer in cooperation with Data Resources, Inc., demonstrate the positive impact of a tax credit on R&D spending, productivity and real GNP growth (see attachment 6).

For example, a 25% tax credit on R&D spending starting in 1966 would have added 0.2 percentage points to annual productivity gains during 1966-77, 0.3 percentage points per year in 1978-87 and 0.4 percentage points per year in 1988-97. To put these numbers in perspective we only need to recall that the total productivity increase in 1978 was 0.4%.

The annual boosts to productivity would have reduced the consumer price index by 0.1 percentage points per year during the first decade, 0.4 percentage points per year in the second decade and 0.6 percentage points per year in the third decade.

The study also examined the impact of tax credits of 10% and 50%. The comparison indicates that the results are not linear but exhibit larger than proportionate gains. For example, in the period 1988-97 when we double the tax credit from 25% to 50%, the R&D outlays increase by a factor of 3.5 and the real GNP delta would increase by a factor of 3.2 to about $326 billion, an amount larger than the United Kingdom's present GNP. Moreover, the 50% tax credit would add one percentage point to productivity and reduce inflation by 1.3 percentage points per year.

An interesting by-product of the analysis reveals the beneficial impact on exports of increased R&D spending. At first the impact is small but it grows progressively larger through time. For instance, a 50% R&D tax credit would add $26.5 billion per year to real exports during 1988-97. This represents a 12% increase over the projected level of real exports during that time frame.

We estimate that the tax cost of this program would average a net loss of $2.3 billion annually for the first ten years. However, in subsequent time periods, the cumulative impact of R&D begins to pay large dividends. Faster economic growth produces larger tax gains and the net tax impact becomes a positive $6.1 billion per year in the second decade, more than offsetting the tax losses in the previous period (see attachment 7). This result, together with the larger gains to be realized in future years, indicates that the R&D tax credit yields positive returns to society as well as to private firms.

As noted earlier, total industrial R&D as a percentage of GNP has dropped from 2.15% in 1963 to less than 1.6% in 1977, creating a gap of about 0.6 percentage points. A tax credit on private industrial R&D would provide the means for closing this gap. A 10% R&D tax credit doesn't have enough punch to accomplish this task within our lifetimes, but a 25%

tax credit would fill the gap shortly after the end of the century. A 50% R&D tax credit would push R&D spending back to its previous peak in less than eight years (see attachment 8).

TAX CREDITS FOR EXPORTS

Increasing capital formation, R&D and productivity gains, as well as controlling the budget deficit and monetary growth, will improve the environment for exports, but this is still not enough. The U.S. share of the world export market is in a serious long-term decline - dropping from 18.0% in 1960 to 11.8% in 1977 (see attachment 9).

The U.S. Export Policy must have as its objective to end this loss of market share and increase exports sufficiently to bring about equilibrium in our trade balance. To reach that objective we must move on two fronts: the elimination of disincentives to export generated by government regulations and the creation of incentives to export. Some examples of disincentives are:

- The imposition of U.S. environmental, health and safety standards on exports to countries that don't share those standards,

- An unclear Foreign Corrupt Practices Act with criminal sanctions for the unwary,

- Overlapping and inconsistent anti-boycott regulations,

- Human rights embargoes,

- Cargo preference laws, and

- Changes in the Internal Revenue Service Code that increase the cost of maintaining Americans abroad.

Perhaps the most important target for correction is the confusing and frustrating export licensing procedure administered by the Department of Commerce. We must change our control efforts to focus on critical technologies rather than on products, which will permit us to protect our national security without strangling exports.

In countries like Germany and Japan, survival depends on export trade. But our market is so large, U.S. businesses aren't compelled to export. We need to jar our economy into awareness of the national need to export.

We can't expect to solve this problem in 1979, but it is clear that we must have dramatic incentives for all U.S. businesses to export. We must put money in the exporters' pockets now in response to good performance. The simplest mechanism is a straight export tax credit. An alternate approach could be to eliminate taxation on the 50% of export income classified as foreign source income.

A more subtle approach would be to modify the Investment Tax Credit to permit a credit of up to 15% of investment in qualified assets* for firms that increase their exports by up to 25% above a base period. The impact of this charge would be to stimulate investment and exports - both highly beneficial to the U.S. economy (see attachment 10).

The main result of two simulations on export tax credits performed with the DRI model are shown in attachment 11. Simulation #1 assumes a 5% export tax credit enacted in 1980. Two-thirds of that credit are given to business in the form of a credit on business equipment and one-third is passed on in reductions

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* Machinery, office equipment, removable fixtures, etc., and some expenditure for rehabilitation expenditures of older buildings.

of export prices. Real investment would increase by $8.4 billion per year (roughly 5% per year) while the volume of exports would rise by $2.2 billion (about 2% per year). Simulation #2 assumes that two-thirds of the export tax credit are translated into lower export prices and one-third is retained in the form of an investment tax credit. Both exports and investment would increase by 3% per year.

Still another approach would be to improve DISC to permit deferral of U.S. income tax on an increased portion of export profits. Or, we could accomplish this deferral by repealing the provisions of the Revenue Act of 1962 relating to foreign base company sales income.

Less controversial, but less effective, incentives should also be implemented.

The tax code should be amended to provide tax credits for export promotion. These would be credits against Federal Income Tax for incremental international market expenses, such as sales trips, new sales offices and costs of trade shows. A ceiling of $50,000 or $100,000 per year would concentrate the benefit of the credit on smaller firms.

The ExIm Bank should be permitted to purchase loans from domestic banks with a wider spread for smaller loans to assist small and medium-size firms in exporting.

The maximum percentage of a loan that the ExIm Bank can guarantee should be increased from 85%, because the fundamental concern of any exporter is whether he will get paid for his goods.

Some of these proposals will be challenged under the General Agreement in Tariffs and Trade (GATT) or the Multilateral Trade Negotiations (MTN) agreements. These incentives are not, however, substantially different from incentives provided by our major trading partners, particularly if we refuse to accept the strained distinction between the remission or rebate of value added and consumption taxes on exports versus the reduction of income taxes on exports.

Finally, to help our trade deficit, we should encourage domestic energy production by quickly removing all price controls. This would provide strong incentives for oil and gas exploration.

Mexico represents a vast potential supplier of traditional fuels to the U.S. We should improve relations with Mexico by adopting a program which would allow Mexicans to work in the U.S. for extended periods and return to their home country after the work is done. By greatly improving their domestic economy, Mexico's recent oil discoveries could be the long term solution to the illegal alien problem while at the same time helping the U.S. in meeting its energy requirements.

Greater emphasis must be placed on the use of coal, and U.S. laws and regulations should facilitate, and not impede, the conversion from oil and gas to coal.

Nuclear energy must play a greater role in the future of all countries. Though highly controversial, present nuclear technology provides energy at competitive prices, and someday, nuclear fusion could provide the earth with a nearly limitless supply of electrical energy.

While nuclear and fossil fuels will continue to be the major sources of energy for the rest of this century, we should take steps now to develop supplemental sources. To this end, research and development on exotic sources of energy must be expanded to provide for the longer term.

The objective we have set to reach equilibrium in our trade balance is ambitious. To achieve it, we must resolve fundamental problems of inflation, reduced productivity and insufficient R&D. We must eliminate disincentives to exports and create incentives which will encourage all U.S. business to attack the export market, aggressively.

These same problems have caused the decline of the dollar, which has eroded business confidence in the U.S., and will eventually encourage exchange controls by foreign central banks and the creation of trading blocs based on other currencies. Solving these fundamental problems of inflation, productivity improvement and export stimulation will reverse the slide of the dollar.

The challenge then is to achieve as a nation the discipline and innovation required to reverse the decline of the U.S. position in world trade. To accomplish this will take a coordinated effort by U.S. industry and U.S. government at all levels, especially the Federal government. The stakes are high. The future health of the U.S. economy -- vital to continued gains in our living standards and to our ability for self-defense -- depends in large measure on our success.

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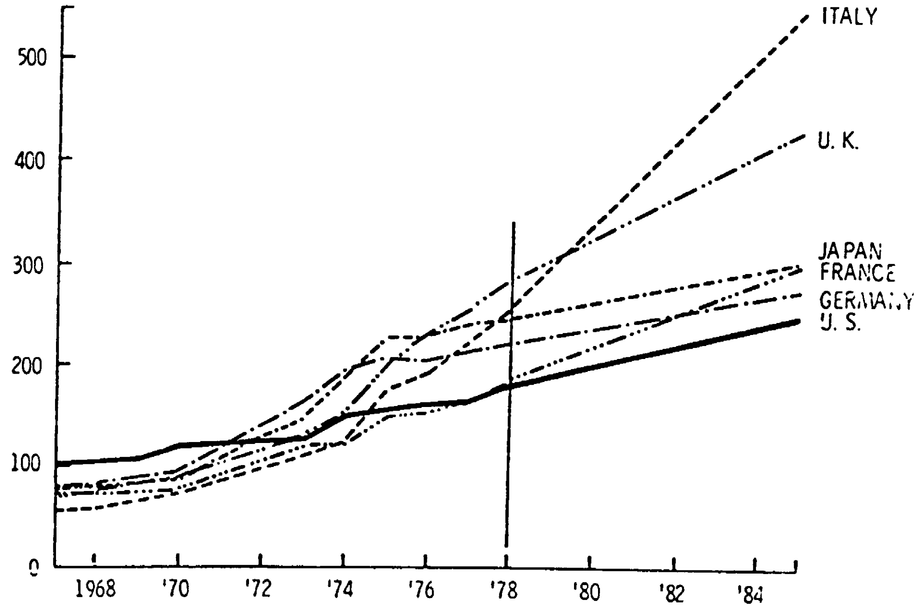
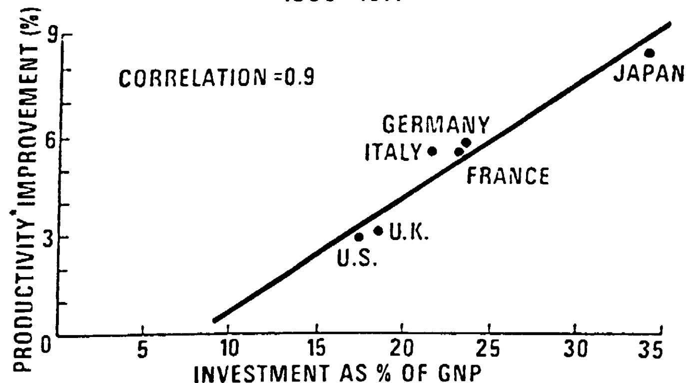
Attachment 1

UNIT LABOR COSTS IN MANUFACTURING
RELATIVE TO U. S. (U. S. Index, 1967 = 100)

(2/79 Exchange Rates)



SOURCE: Citibank and
Texas Instruments Incorporated



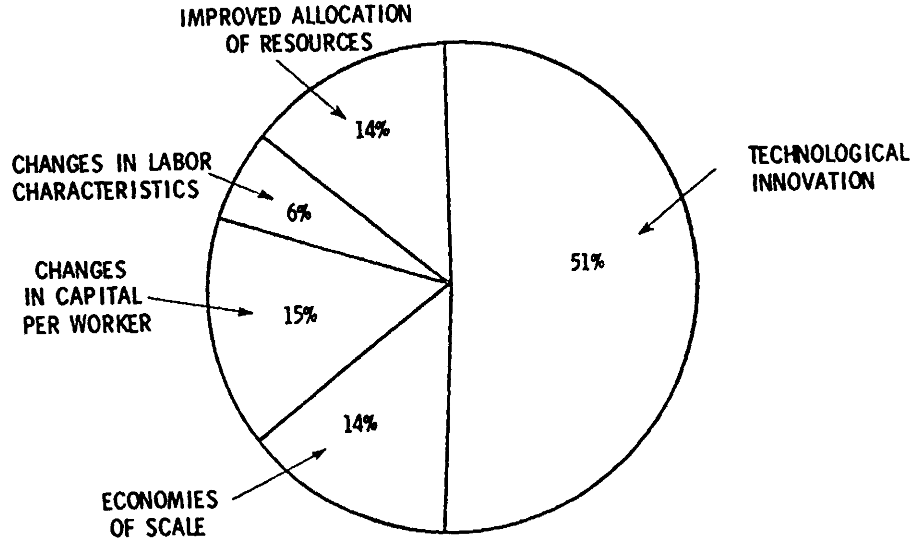
* Output per Man-hour in Manufacturing

Attachment 2

Countries with a higher proportion of GNP devoted to business investment also have higher productivity increases. Japan, investing 33% of GNP, had productivity growth close to 9%. Most countries in Western Europe invested close to 20% of GNP and their productivity gains averaged about 5%. Productivity growth in the U.S. hovered between 2% and 3%, with less than 15% of GNP allocated to investment.

SOURCE: IMF and U.S. Depart of Commerce
<u>International Economic Indicators</u>

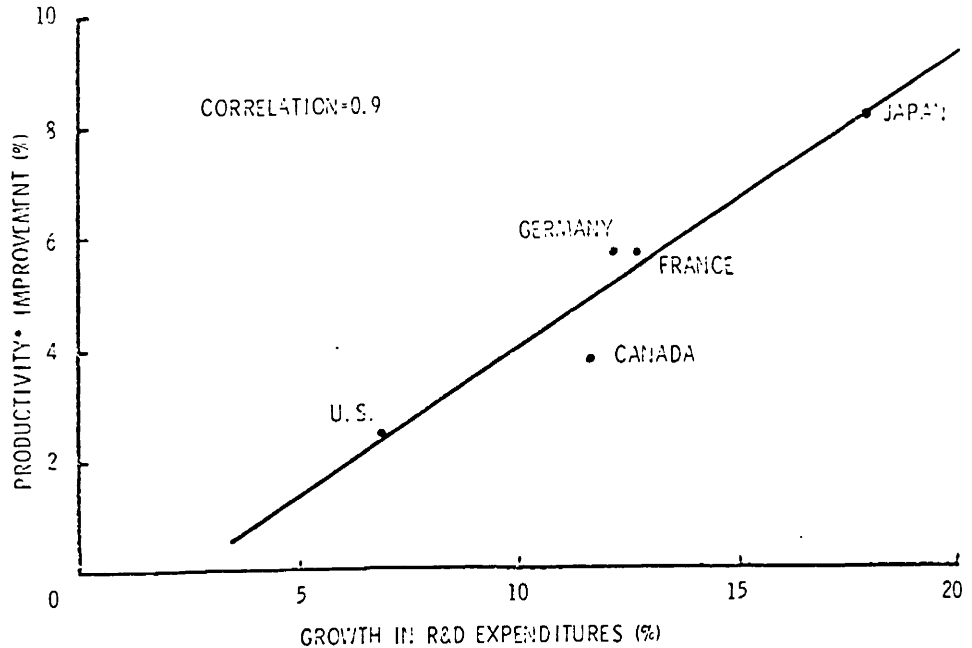
SOURCES OF PRODUCTIVITY GROWTH
IN THE U.S.
(1948-1969)



Attachment 3

SOURCE: Edward F. Denison,
The Brookings Bulletin, Vol. 15, No. 2

R&D IMPROVES PRODUCTIVITY
(1963-1977)

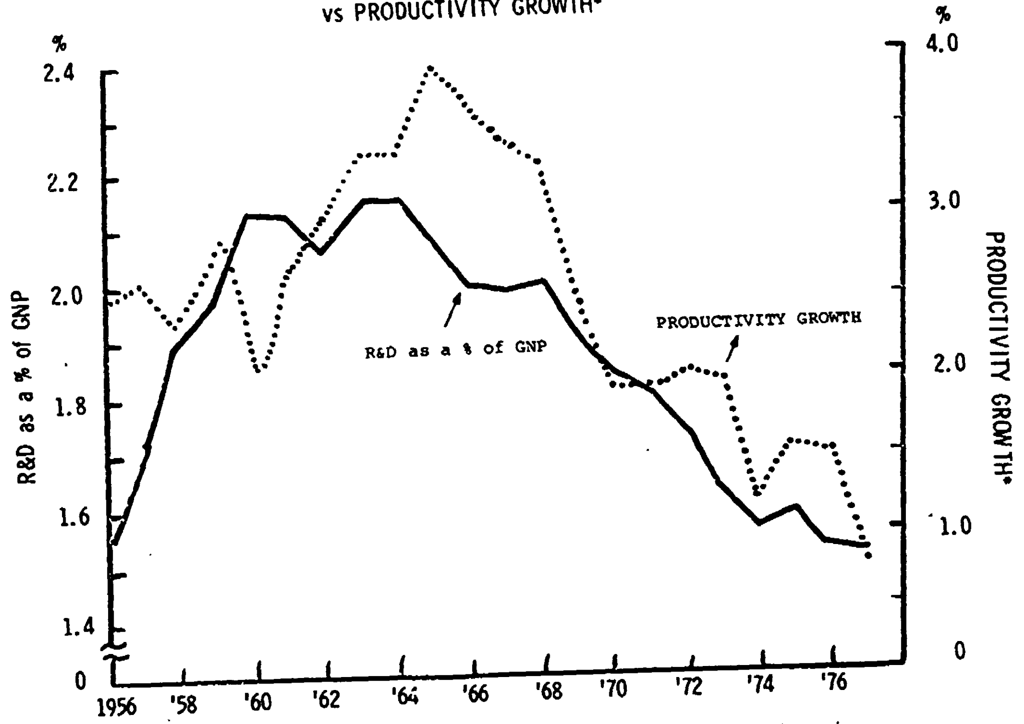


* Output per Man-hour in Manufacturing

SOURCE: National Science Foundation and U.S. Department of Commerce

Attachment 4

U.S. INDUSTRIAL R&D AS A % OF GNP (1972 $)
vs PRODUCTIVITY GROWTH*



* Productivity growth is a 5-year moving average of output per manhour in the private business sector.

SOURCE: Data Resources, Inc., and U.S. Department of Commerce

Attachment 5

IMPACT OF ALTERNATIVE R&D TAX CREDITS

(AVERAGE ANNUAL CHANGE FROM DRI BASELINE FORECAST)

	1966-77			1978-87			1988-97		
	10%	25%	50%	10%	25%	50%	10%	25%	50%
PRODUCTIVITY GAINS (% PTS)	0.07	0.21	0.63	0.10	0.28	0.78	0.12	0.36	1.01
CPI (% POINTS)	-0.03	-0.13	-0.42	-0.16	-0.42	-1.08	-0.23	-0.63	-1.30
BILLION 1972 $									
R&D	0.7	2.1	6.4	1.7	5.2	16.8	3.4	10.6	36.7
GNP	1.4	3.7	11.6	12.3	36.2	105.6	33.7	101.7	325.9
EXPORTS	0.1	0.2	0.6	0.1	1.7	6.5	0.3	6.3	26.5

SOURCE: Data Resources, Inc.

Attachment 6

TAX COSTS/BENEFITS OF ALTERNATIVE R&D TAX CREDITS

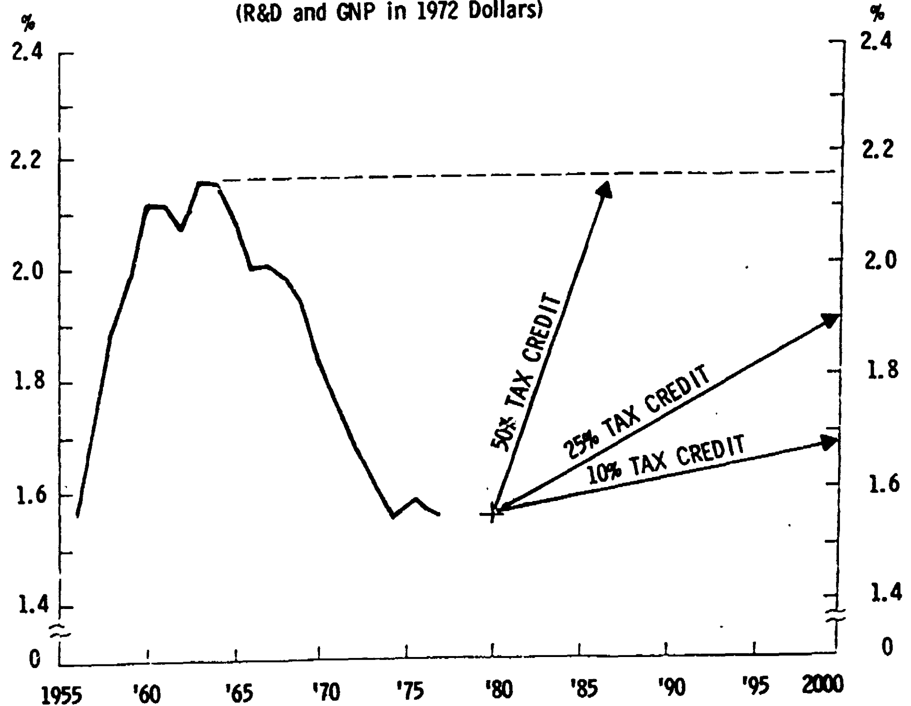
(B 72$, AVERAGE ANNUAL CHANGE)

	1966-77			1978-87			1988-97		
	10%	25%	50%	10%	25%	50%	10%	25%	50%
COST/YEAR	-1.2	-3.4	-8.9	-1.8	-5.5	-16.8	-2.7	-8.6	-30.2
GAIN/YEAR	0.4	1.1	3.6	3.9	11.6	33.8	10.8	32.5	104.3
NET IMPACT	-0.8	-2.3	-5.3	2.1	6.1	17.0	8.1	23.9	74.1

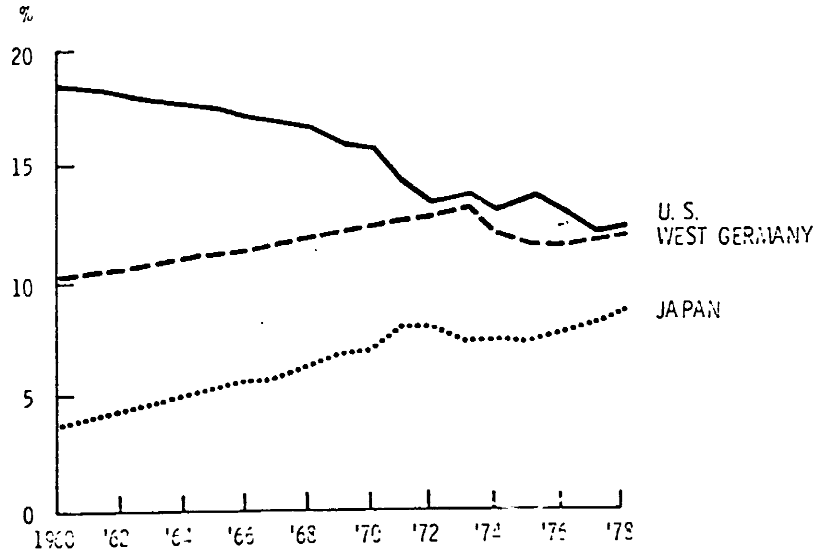
Attachment 7

SOURCE: Texas Instruments Incorporated

Attachment 8



SHARES OF WORLD EXPORTS*

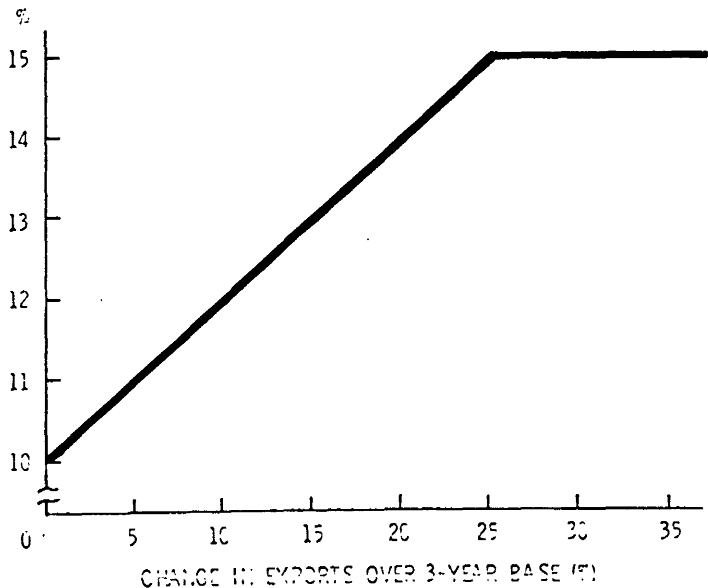


* Excludes Exports from Communist Areas

SOURCE: U.S. Department of Commerce
<u>International Economic Indicators</u>

Attachment 9

EXPORT TAX CREDIT
via
CHANGE IN THE INVESTMENT TAX CREDIT



NOTE: The export tax credit is restricted to less than 10% of the change in billings.

SOURCE: Texas Instruments Incorporated

Attachment 10

IMPACT OF ALTERNATIVE 5% EXPORT TAX CREDITS -- 1980-1984
(AVERAGE ANNUAL CHANGE FROM DRI BASELINE FORECAST)

BILLIONS OF 1972 $	SIMULATION 1	SIMULATION 2
GNP	10.1	7.0
INVESTMENT	8.4	4.4
EXPORTS	2.2	4.2

SIMULATION 1, ASSUMES 2/3 RETAINED AS AN INVESTMENT TAX CREDIT AND 1/3 PASSED ON THROUGH A REDUCTION IN EXPORT PRICES.

SIMULATION 2, ASSUMES 1/3 RETAINED AS AN INVESTMENT TAX CREDIT AND 2/3 PASSED ON THROUGH A REDUCTION IN EXPORT PRICES.

SOURCE: Data Resources, Inc.

Attachment 11

Senator BYRD. The next witness is Robert A. Best, executive vice president of the American League for Exports & Security Assistance, Inc.

Mr. Best, the committee is pleased to see you again. The committee remembers the fine contributions that you gave to this committee and we welcome you today.

STATEMENT OF ROBERT A. BEST, EXECUTIVE VICE PRESIDENT, AMERICAN LEAGUE FOR EXPORTS & SECURITY ASSISTANCE, INC.

Mr. BEST. Thank you, Mr. Chairman.

We welcome this opportunity to provide our views on the need for a positive export trade program.

The American League for Exports and Security Assistance is a unique labor-management organization. Founded in 1977, it has as its charter and principal goal the development and implementation of policies to encourage American exports. The 34 corporations, employing over 800,000 workers, and the 4 international unions, representing 4.1 million American workers, in the ALESA membership firmly believe that the United States needs to adopt a national policy that encourages the production and export of American-made goods and services if we are to achieve the goals of full employment, price stability and preserving the integrity of the dollar.

We are delighted that members of this committee have taken initiatives to encourage U.S. exports. We only hope that the Congress as a whole and the administration would see the critical importance of exports to our economy.

The economic strength of this Nation is rapidly being eroded by the vicious cycle of: Massive trade deficits begetting dollar weakness; begetting domestic inflation; leading to tight money, or economic controls, which inevitably will create a recession and again a return to a massive budget deficit situation.

The May issue of "Economic Indicators," published by Joint Economic, showed a trade deficit rate of $36.2 billion during the first quarter of 1979, and a budget deficit of the national income accounts of $18.4 billion. Based on these data, I cannot see the improvement referred to by the first witness, Mr. Sunley.

Mr. Chairman, we do not have all the answers, but we do strongly believe that we cannot continue for very long to permit the vicious cycle described above to persist.

We do know that every $1 billion worth of exports creates 40,000 to 50,000 jobs and every 1 million jobs creates in corporate and individual taxes $22 billion in revenue to the U.S. Treasury.

Those are estimates of the Congressional Budget Office used by Majority Leader Jim Wright. Assistant Secretary of the Treasury, C. Fred Bergsten, has used even greater estimates of the job and income creating effects of exports in his speeches.

Given the multiplier and feedback effects of exports on jobs, income and revenue, if we only increased the ratio of exports to GNP by 1 or 2 pecentage points, we would eliminate the fiscal deficits and gainfully employ another 1.6 million Americans. That would be the best human rights program for American workers and investors I can think of.

We strongly believe that America's greatest long-term strength—our industrial base—depends importantly on the high technology sector where we have maintained our only competitive advantage. This in itself becomes an ever increasingly important factor in our overall long-term national interest.

Across America, there is the growing sense that we as a nation are falling behind in the competitive race, that our spirit of innovation is gone, that we have become an overregulated, welfarized, lethargic, and divided nation incapable of coming to grips with our problems.

There has been in recent years a dangerous erosion in the ability of U.S industry—particularly high technology industry—to compete in the world marketplace. A major reason has been the anti-export policies of the Government which inhibit and discourage exports through laws, licensing procedures, regulations, and other disincentives.

In contrast to U.S. policy, other major industrial nations have developed positive export programs to provide jobs in the private sector through domestic production for export and to earn through exports the foreign exchange needed to pay for energy imports.

In fact, Mr. Sunley, his statement indicated as much in that portion of his statement he did not choose to read.

One has only to compare the $39.6 billion deficit, c.i.f. basis, of the United States with the $20.3 billion surplus, c.i.f. basis, of Germany and the $18.3 billion surplus, c.i.f. basis, of Japan to recognize that those countries—despite the appreciation of their currencies, despite their 80–95 percent dependency on imported energy—have overcome external problems and maintained high levels of employment and, particularly in Germany's case, relative price stability.

Germany and Japan have surpassed the United States as the leading exporter of manufactured products. They beat our brains out in competition while we generously spend billions to defend their freedom. While we should defend freedom, we cannot do it with a weak domestic economy or a continuous decline in our competitiveness. These facts underscore the critical importance of a positive export policy for security as well as domestic economic reasons.

Mr. Chairman, the domestic budget cannot be balanced as long as our Nation maintains a passive approach to exports and permits the stagflationary effects of massive trade deficits to continue. Why? Trade deficits of the magnitudes we have experienced severely weaken the dollar; drive up the costs of imports, including energy; thereby inducing inflation which leads either to controls or recessions, or both, thus creating further domestic budget deficits. As long as the economy remains weakened by stagflation, it will be impossible to balance the Federal budget.

The massive inflation-inducing trade deficits are symptomatic of a deeper problem than the simple line heard frequently by administration officials, paraphrased as follows: "If we did not import $50 billion in oil each year, we would be in great shape." That is the reasoning of a defeated and/or bankrupt policy, not a positive, aggressive approach. It is really more of an excuse for a laissez-faire approach to the inflation-inducing effects of structural trade

deficits. When you do not really want to solve the problem, you lay the blame at someone else's doorstep.

The sponsors of the four bills mentioned in the committee press release are taking a positive approach to the structural trade deficits. Senators Bentsen and Danforth correctly analyzed the long-term nature of the problem, the importance of R. & D. to our competitive position and the relationship between trade deficits, inflation, and jobs.

They are well thought out bills that deserve your attention.

Inevitably, the proposals will be costed out by Treasury and the joint committee staff. Hopefully, they will add a rational feedback for the proposals. Simply assuming that despite added tax incentives, R. & D. efforts will not be changed, will doom any intelligent tax program before it gets off the drawing boards.

The critical issues involve which combination of writeoffs and credits will get the most bang for the buck.

Having served on this committee's staff for over 10 years, I have learned to be very suspicious of official Treasury revenue estimates. I am sure many members witnessing the yo yo pattern of revenue estimates are also skeptical.

More often than not, these official estimates appear to tailor assumptions to reach foreordained conclusions. I could cite many examples under both Democratic and Republican administrations, but will not take your time to do so, unless requested.

We completely agree, Mr. Chairman, with the emphasis in the proposals on encouraging medium-sized and smaller companies to be exporters. We should do everything reasonable to encourage these companies to get into the export market.

However, we cannot fail to mention that exports are, and will remain, a big business. The risks are great.

Currency fluctuations and exchange rates, U.S. and foreign regulations, to name a few, are very complex to deal with, and smaller companies are often discouraged before they get into the ball game.

In considering these bills Congress should avoid, therefore, the trap of clobbering big business with punitive measures to theoretically recover sufficient revenues to subsidize small business. Big business still provides the majority of the jobs, the income and the taxes that make the economic machine work.

In fact, big business, in many instances, keeps small businesses alive, through billions of dollars worth of subcontractors and supplier relationships.

Mr. Chairman, I can submit for the record a series of recommendations by a distinguished group of private citizens headed up by Bill Norris, chairman of Control Data, which suggests tax incentives for small business.

[The material referred to follows:]

RECOMMENDATIONS FOR CREATING JOBS THROUGH THE SUCCESS OF SMALL, INNOVATIVE BUSINESSES

A Report to the Assistant Secretary of Commerce for Science and Technology

This report, prepared under the direction of William C. Norris, Chairman of the Board and Chief Executive Officer of Control Data Corporation and a member of the Commerce Technical Advisory Board, represents the views of a Work Group of private citizens, each of whom has had unique and valuable experience in technology and entrepreneurship.

December, 1978

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Department of Commerce Liaison: Theodore Schell

EXECUTIVE SUMMARY

Job shortage in the United States is the most important consequence of our recent decline in technological innovation. Jobs are at the heart of American society, but we don't have enough of them, and we aren't creating new ones fast enough, particularly skilled jobs.

The shortage of jobs underlies our blighted inner cities and poverty stricken rural areas where residents, reliant on welfare, are bereft of the means to regain control of their personal lives to rise above the squalor. It also underlies the unemployment rate of nearly 35 percent for minority teenagers. This means a paucity of career opportunities that will attract their commitment to self-improvement programs as realistic alternatives to lives dominated by despair, desolation, and crime.

The ability of our economy to carry out technological innovation -- to introduce commercially successful new products, services, and processes -- is the foundation of both our domestic prosperity and our international competitiveness. Because innovation is such a key factor in our economy, it supports much of our real economic growth, which in turn permits a rising standard of living and provides a solution to the stubborn problem of stagflation -- rising prices combined with high unemployment.

Internationally, our historic preeminence in technological innovation is being challenged by other industrial nations, Japan and West Germany in particular. The challenge is explicit. It is shown clearly by recent trends in several international economic indicators -- the falling value of the dollar, our declining share of world exports, and our negative trade balances in manufactured goods. Continuation of these trends promises the loss of U.S. leadership in technological innovation and a further deterioration of our economic health.

Given their brilliant performance of the 50's and 60's small businesses* again could play a major role in providing more jobs and make significant contributions to the solutions of the underlying problems of our economy. The performance of the small business sector could be stimulated to provide these benefits by changes in federal policy and commercial practices and without increases in federal budget support. Whatever early losses in federal revenues they may cause are expected to be offset by subsequent gains from the resulting spurt in economic activity.

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* Throughout this report small businesses are defined as those that have less than 500 employees, are not majority owned by larger firms, are operated for profit, and are involved in the creation or creative use of new knowledge, products, processes, or services. Activities related primarily to real estate transactions are excluded.

Throughout most of our history, small enterprises have produced many of our best jobs; a large proportion of the new products and services that have made us the world's leading nation in science, engineering, and technology; and a steady supply of creative entrepreneurs. But the contributions of small firms have sharply declined over the last decade. We believe the underlying causes are mainly certain growth-inhibiting government policies.

One is the increase in capital gains taxation, which has greatly reduced the availability of capital for small businesses. Another is increased regulatory barriers inhibiting the access of small firms to the capital market. A third is the continuing concentration of research and development effort in a few industries and in relatively few firms within those industries, and little incentive to diffuse technologies.

Increased technological innovation appropriate to the small family farm and food processor is also needed. Rising costs of energy, plateauing productivity of major food crops, increasing scarcity of water, continuing high levels of pollution, and decreasing fertility from erosion mandate that small farms and food processors also be made significant and lower-cost contributors to the nation's food supply.

The overall objectives of the recommendations in this report are:

1. To assure that the small enterprises regain their previous economic vitality, and

2. To foster the viability of the small family farm and small food processor through development and application of technologies that require less capital and fossil fuel, and are more conserving of other natural resources.

The following 12 recommendations are directed to changes in federal policies and commercial practices in five categories:

●●● Increasing the availability of capital and management expertise in small businesses (Recommendations 1-5).

●●● Reducing the burden on small businesses of compliance with government regulations (Recommendation 6).

●●● Stimulating the diffusion to and more effective application by small businesses of the technology developed in government laboratories and large businesses (Recommendations 7 and 8).

●●● Increasing the amount of R&D performed by small businesses and its utility to small farms and food processors (Recommendations 9, 10, and 11).

••• Stimulating the export performance of small businesses (Recommendation 12).

While we recognize the potential significance to small businesses of issues relating to the U.S. patent system and federal patent policy, we exclude recommendations for policy changes in this area because it is under active review by the Domestic Policy Review on Industrial Innovation and by the Committee on Intellectual Property and Information of the Federal Coordinating Council for Science, Engineering, and Technology.

The complete text of each recommendation follows:

Recommendation 1.

We recommend that the capital gains tax rate be reduced to 25 percent (the pre-1969 rate) on the capital gains realized from the sales of stocks of small businesses (less than 500 employees at date of purchase) whenever such stocks have been held for more than three years, with a rate of 10 percent for the capital gains of investors in the smallest businesses (less than 100 employees at date of purchase). The reduced rates would not apply to capital gains realized from the sale of real estate. (Pages 15-18)

Recommendation 2.

We recommend deferral of capital gains taxes on the sales of stock if the proceeds are reinvested within one year in small businesses, except those whose principal activities are real estate transactions. (Pages 18-19)

Recommendation 3.

We recommend that the threshold for application of the full corporate tax rate of 46% be raised from $100,000 to $200,000 of annual net income; and for annual net income below $200,000 a progressive rate schedule beginning at 10% on the first $50,000, and increasing in 10% increments to $200,000 on each additional $50,000. In addition we recommend that the carry-forward provisions for start-up losses of small businesses be extended from five to ten years. (Pages 19-20)

Recommendation 4.

We recommend restoration of the Qualified Stock Option Plan for Key Employees of small businesses. (Pages 20-21)

Recommendation 5.

We recommend (1) that ERISA's prudent man standard be restated so that it is clearly applicable to the total portfolio of pension fund investments rather than individual investments, and (2) that pension fund managers explicitly be permitted to invest up to five percent of pension fund assets in small firms. (Page 21)

Recommendation 6.

We recommend that small businesses be allowed to deduct twice their payments for regulatory advisory services related to compliance with federal, state, and local regulation. (Pages 22-23)

Recommendation 7.

We recommend that each federal agency allocate five percent of its R&D funds for technology transfer. These funds should be used to establish well defined and organized programs of technology transfer in which there are incentives to individual researchers to contribute their time and skills to the identification of commercial applications. Such incentives should be related to the benefits realized from technology transfer. (Pages 23-26)

Recommendation 8.

We recommend that private sector individual or corporate owners of technology be rewarded, through appropriate changes in the tax code, for selling, leasing, or licensing their technology to small business firms in the United States. In addition, we recommend the establishment of a voluntary national policy to encourage companies to make their technologies available for uses by others. (Pages 26-27)

Recommendation 9.

We recommend that each federal agency receiving R&D funds by appropriation from the Congress be required to allocate at least 10 percent of all such funds (excluding those for basic research) to small businesses and that this objective be achieved in annual 1% increments beginning in FY1980. (Pages 27-30)

Recommendation 10.

We recommend that small business firms be allowed to establish and maintain a reserve for R&D for use in times of financial stress. (Pages 30-31)

Recommendation 11.

We recommend that there be some redirection of federally supported agricultural research to the development of technology for improving the efficiency of small family farms and food processors and for making food production, transportation, and preservation less capital and fossil-fuel intensive. (Pages 31-33)

Recommendation 12.

We recommend that the creation of Small Business Export Trade Corporations be encouraged by a double deduction for these corporations of up to $100,000 of annual expenses associated with the exporting activities of each client, with a loss carry-forward of ten years. In addition, we recommend that small businesses be allowed a double deduction of special expenses of serving export markets up to $100,000 annually. (Pages 33-34)

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I. INTRODUCTION

This report recommends changes in federal policies to increase the contributions of small, technologically innovative firms to our society. We define such firms as those that have less than 500 employees, are not majority owned by larger firms, are operated for profit, and are involved in the creation or creative use of new knowledge, products, processes, or services. We exclude throughout the report activities related primarily to real estate transactions.

The small business sector no longer contributes as much to economic prosperity as it so brilliantly did in the fifties and sixties. The loss is not just for the few that might have had the satisfaction of technological entrepreneurship; more importantly it is a loss for all Americans who would have shared in the abundant economic benefits and would have held the myriad of skilled jobs that such pioneering would have made possible.

More innovation means more skilled jobs for an increasingly educated population, an improved export performance, a higher rate of productivity improvement, and at least a partial solution to stagflation, a crippling combination of inflation and unemployment. Further, we desperately need more innovation to cope with both new problems and widely accepted national goals - - better central cities, safer and more satisfying work, a cleaner environment, and less dependence upon autocratically controlled overseas sources of energy supplies. We need to recognize the growing concern over the quality of life in our country - - concern that technological innovation is not focusing adequately on both life's necessities of food and housing and on the amenities that make life more enjoyable. We think commercially successful innovation is like good health: a society can never have too much.

Our concerns span the entire spectrum of requirements for successful innovation - - from the inception of the research and development (R&D)[1] tc the widespread use of a new product, process, or concept. We look then well beyond research and development (that is, activities to create new knowledge or design) to encompass the introduction and diffusion of an invention through its commercial application that creates jobs, increases productivity, and adds to exports. Thus successful innovation requires a combination of market demand (need), technical feasibility, and commitment of financial support. This combination ultimately is manifested in the establishment of all of the producing and marketing facilities required for national and international distribution of the product or service. Hence, our report deals not only with the role of scientist, engineer, and inventor, but also that of the financier, the production craftsman, and the marketing person; all are involved in bringing an invention into widespread use.

[1]Research and development includes (1) basic research (acquiring scientific knowledge), (2) applied research (acquiring knowledge for potential application), and (3) development (designing special materials, devices, processes, and products).

We recognize that federal policies alone cannot cause small, technically oriented firms to flourish. Their existence depends on the entrepreneurial spirit that has been an integral part of our culture and institutions, and they have contributed importantly to our economic strength. Other industrialized countries do not have so large a sector of technically oriented small businesses, which explains in large part their historic lack in innovation. In recent years however they have recognized this deficiency and instituted policies to encourage the development of small technically oriented companies. At the same time, policy changes in the United States have had largely unintended adverse consequences.

Our recommendations are to reshape certain existing policies to make them less of a handicap to business, rather than to expand the government into new areas. We stress that our recommendations involve no increase in federal budgetary support, but they probably would cause an initial reduction in federal revenues.

The report is focused on what can be done: measures that will pay off to society. As a prelude to such recommendations, we believe it is important to review briefly what we regard as the present crisis in innovation and its consequences.

II. CONSEQUENCES OF THE SLOWDOWN IN INNOVATION

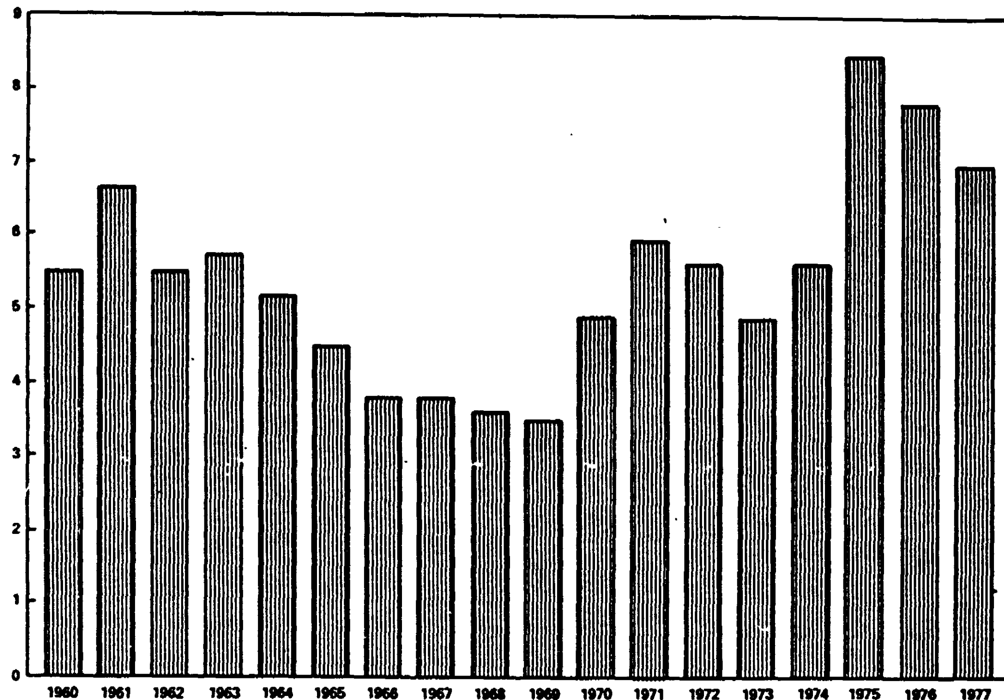
The loss of the potential contribution of the small, technically oriented firm and more generally the decline in innovation in our economy have wide-ranging ramifications for jobs in the United States, our trade position, our productivity, the general performance of our economy, and our ability to meet the new problems our society faces.

A. Jobs

Unemployment in the United States throughout the nineteen seventies has persisted at unacceptable rates (See Figure 1.). It is increasingly recognized as a stubborn problem that is not solvable by fine tuning of national fiscal and monetary policies. Nor is the creation of temporary and dead-end jobs in the public sector more than a palliative. Training programs go nowhere without viable jobs for their graduates.

Holding a meaningful skilled job is also recognized as the means of admission to most of the benefits of a prosperous society and to full citizenship in economic, social, and political life for an individual and his family. Alternating periods of unemployment and dead-end jobs leave their scars on successive generations.

Finally, the concentration of unemployment and underemployment among particular groups and localities means explosive social problems. The consequences of unemployment spread through the neighborhood to encompass its small businesses, its public services, and its education system so as to poison the social atmosphere of sections of our country.



SOURCE: 1960–69, INTERNATIONAL ECONOMIC REPORT OF THE PRESIDENT, WASHINGTON, 1977, p. 146
1970–77, ECONOMIC REPORT OF THE PRESIDENT, WASHINGTON, 1978, p. 291

Figure 1. Unemployment in the United States, 1960-77, in Percent of All Workers

The solution must be found in job creation - - particularly skilled jobs - - in the private sector. Innovation plays a key role, for high employment has been associated with the development of new industries and products, founded on new technology; and small businesses have an impressive record of creating new jobs through new technology. A previous study for the Commerce Technical Advisory Board found that from 1969 to 1974 employment increased at an annual rate of only 0.6 percent in a sample of large mature companies, at a rate of 4.3 percent in established but innovative companies, and at a rate of 40.7 percent in young high technology companies.[2] (See Figure 2.) Of course, the success of new products may result in the displacement of old products. Still the process of innovation - - the adding of new products to the economy - - stimulates demand and investment. It permits noninflationary growth in overall demand and offers escape from the dilemmas of continuing stagflation.

B. Export Performance

The strength of the dollar rests ultimately on our success as a trading nation. The postwar pattern in U.S. trade is a relatively simple one. We have deficits - - more imports than exports - - in minerals, fuels, and other raw materials as well as in less technologically intensive manufacturing products such as textiles and shoes. We cover these deficits by surpluses - - more exports than imports - - in such technologically intensive products as aircraft, chemicals, and electronics. Also contributing significantly to the surplus is trade in agricultural products. Much of our success in agriculture is based on the high level of innovativeness displayed by American farmers and their supplying industries, underscoring the importance of including small farms and small food processors within the concept of innovative small businesses.

While our trade in agricultural products continues to provide a significant surplus (See Figure 3.), the recent record of trade in manufactured products is depressing. As shown in Figure 4, the U.S. share of world exports of manufactured goods has dropped alarmingly over the past 20 years. Traditionally, we have been a net exporter of manufactured products, but our imports of such products by 1972 grew to exceed exports, creating one of the factors in the U.S. devaluation decision. With the price advantage

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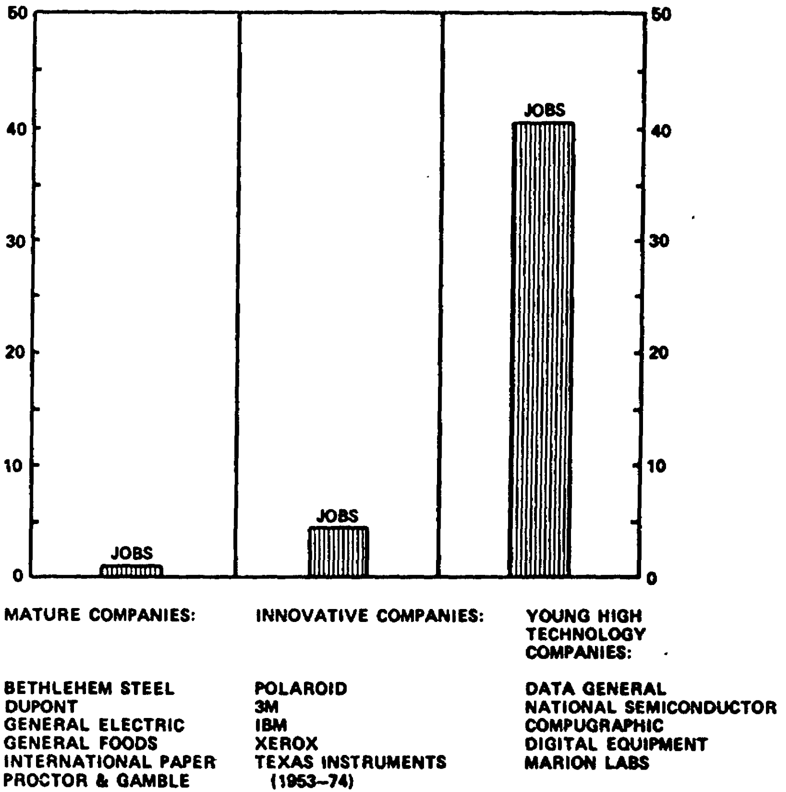
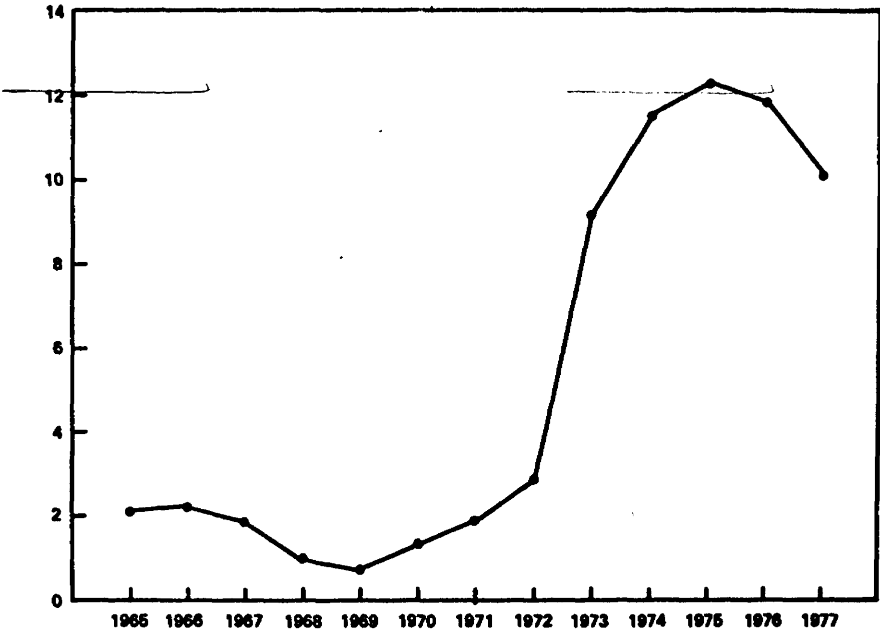
[2]The Role of New Technical Enterprises in the U.S. Economy (A Report of the Technical Advisory Board to the Secretary of Commerce, 1976) Appendix A. See also the statement of Dr. Edwin V.W. Zschau, Chairman, Capital Formation Task Force of the American Electronics Association, before the Senate Select Committee on Small Business, February 8, 1978.



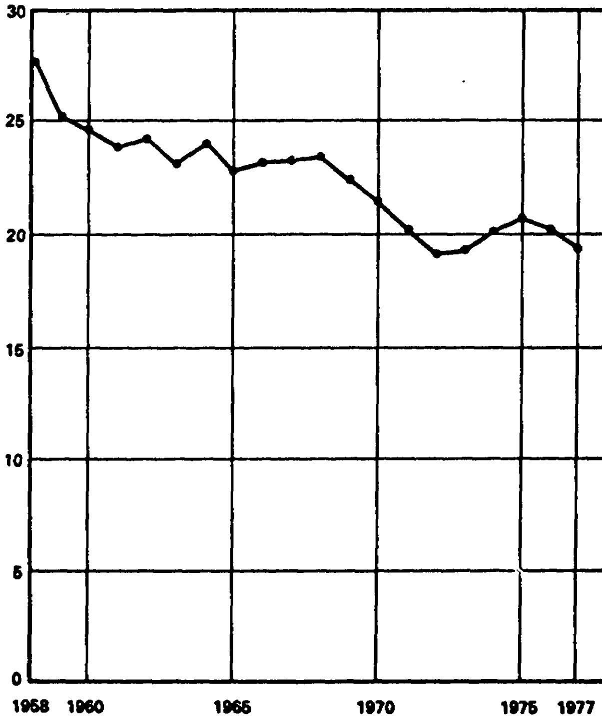
SOURCE: THE ROLE OF NEW TECHNICAL ENTERPRISES IN THE U.S. ECONOMY. A REPORT OF THE COMMERCE TECHNICAL ADVISORY BOARD TO THE SECRETARY OF COMMERCE, JANUARY 1976, p. 2.

Figure 2. Average Annual Growth of Jobs in Innovative Companies, Mature Companies, and Young High Technology Companies, 1969-74, in Percent (Compounded)



SOURCE: 1965–76: INTERNATIONAL ECONOMIC REPORT OF THE PRESIDENT, JANUARY 1977, p. 151. 1977: U.S. DEPARTMENT OF COMMERCE, OFFICE OF INTERNATIONAL ECONOMIC RESEARCH.

Figure 3. U.S. Foreign Trade in Agricultural Products, 1965-77 (Balance in Billions of Dollars)



SOURCE: COMMERCE AMERICA, JUNE 19, 1978, p. 9.

Figure 4. U.S. Share of World Exports of Manufactured Goods, 1958-77, in Percent

from the 1973 devaluation, trade in manufactured products by 1975 generated a 22 billion dollar surplus. By mid-1978, however, our trade surplus in manufactured goods disappeared, which also demonstrates the decline in the U.S. competitive position in manufactured products. (See Figure 5.)

The decline in the balance of trade with respect to manufactured products underlines the importance of continued innovation. Economists have shown the existence of a product cycle in which new products tend to be developed and introduced in industrialized countries and particularly in the United States. Such products are exported to the rest of the world in their early years. But as products become standardized, their technology well known, and their market acceptance widespread, other countries, especially those with lower wage rates, begin their manufacture, first for their home market, and then for export, and at times even to the innovating country.[3]

In this product cycle our advantage has traditionally been in innovation and, as products mature, we must innovate new or improved products and create new processes. In this way we can remain both a successful trading nation and a high-wage country. The American trade problem originates, in part, with the declining innovativeness of our economy relative to those of other countries.

Another of our advantages has been the high productivity of our agriculture. The small family farm, however, is not realizing its potential in contributing to both agriculture exports and domestic consumption because not enough agricultural research has been directed to technological innovations that are responsive to its needs.

C. Productivity

One way the U.S. can offset the effects of its high wages in international competition is by increasing productivity - - more output per worker. Greater productivity is also significant domestically for it permits combining rising wages with stable prices. And in the long run, more output per worker creates the economic growth that has allowed each generation to live better than its parents.

While output per man-hour in manufacturing doubled in the United States from 1950 to 1976, it increased nine times in Japan, more than four times in West Germany, and nearly four

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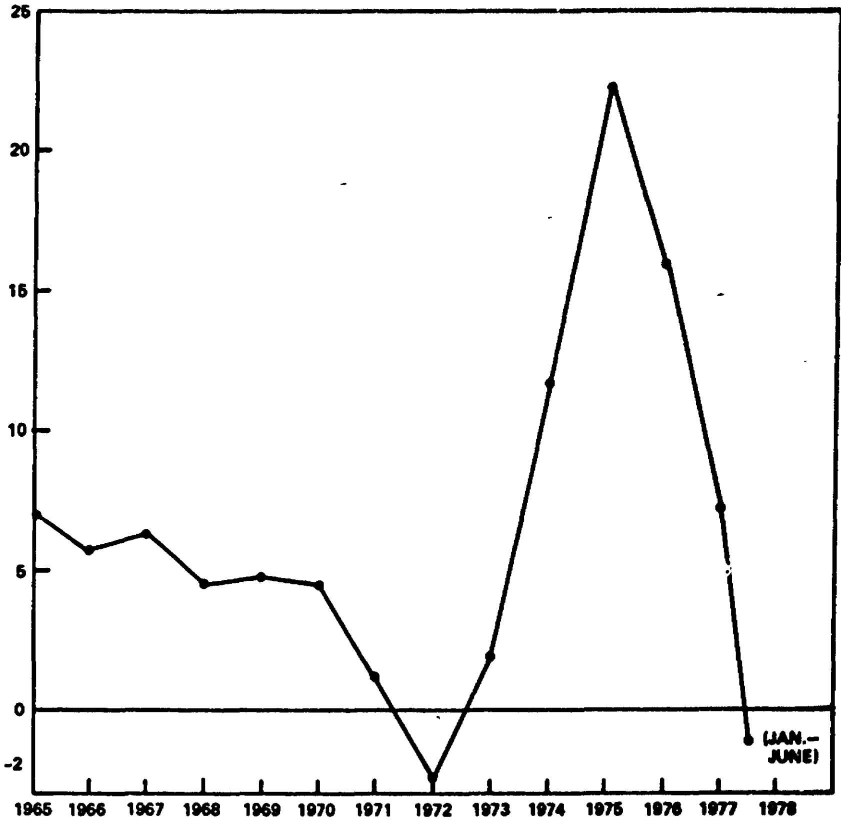
[3]Raymond Vernon, "International Investment and International Trade in the Product Cycle, "Quarterly Journal of Economics, Vol. LXXX (May, 1966).



SOURCE: 1965–76: INTERNATIONAL ECONOMIC REPORT OF THE PRESIDENT, JANUARY, 1977, p. 152. 1977–78: U.S. DEPARTMENT OF COMMERCE, OFFICE OF INTERNATIONAL ECONOMIC RESEARCH.

Figure 5. U.S. Foreign Trade in Manufactured Goods, 1965-78 (Balance in Billions of Dollars)

times in France. Among the industrialized countries, only the United Kingdom had an increase comparable to that in the United States. (See Figure 6.) While the record of other countries reflects a recovery from World War II destruction, and some catch-up in productivity was inevitable, the productivity record of the United States during the last decade has been disappointing relative to that of other countries, and to that of our own recent past.

Innovation plays the fundamental role in productivity gains. The effect of innovation is most direct with process innovations -- improved methods of producing existing products which raise output per man-hour. New products affect productivity more indirectly. A new product of one industry -- such as a computer, a machine tool, or a new material -- will often raise productivity in the firm that purchases the new product. Various studies have shown that innovations in these two forms are the major sources of productivity growth.[4]

Another factor in productivity has been the rise of the service sector. While services broadly defined were about half the economy at the end of World War II, services now account for two-thirds of the U.S. economic output.[5] Services have traditionally had a slow rate of productivity increase, but the reduction in clerical costs with the use of computers and office machines illustrates what can be achieved with new products and new methods. With a large and growing service sector, innovation is of critical importance both in the service sector itself and in the manufacturing industries that supply both improved products and new ones. Moreover, in the service sector small businesses play a larger role than they do in manufacturing.

D. Stagflation

While the causes of stagflation are not well understood, there is evidence that a declining rate of innovation compounds and intensifies the forces leading to stagflation. This is because it is in the highly innovative sector that marked price declines occur. To take three examples from innovative industries: (1) the price of the transistor by 1965 fell to one hundredth of its 1951 value, (2) the price of a long distance

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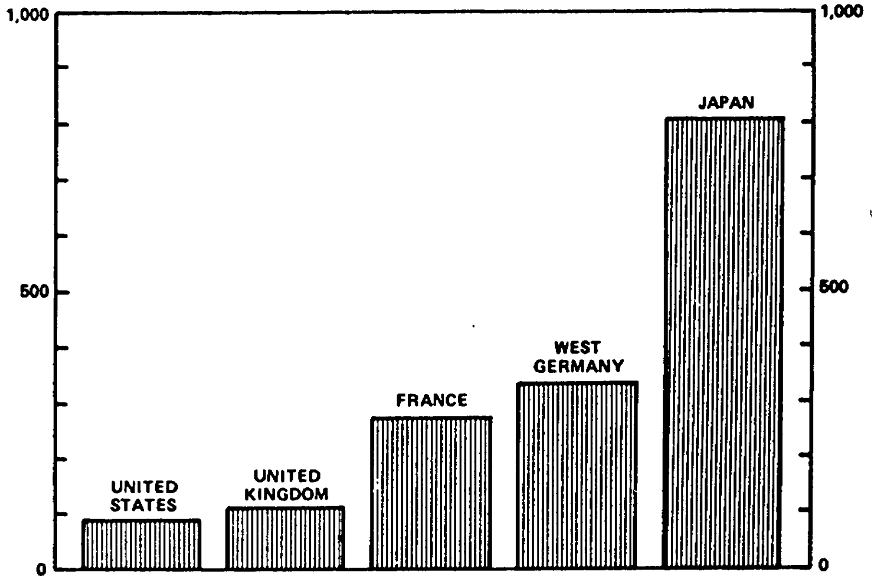
[4]While productivity is often measured as output per worker, total factor productivity is a more comprehensive measure because it reflects the role of increased capital per worker. Again, however, innovation plays the key role in raising total factor productivity. See, for example, Edward S. Denison, Why Growth Rates Differ (The Brookings Institution, 1967), pp. 7-9.

[5]U.S. Department of Commerce, U.S. Service Industries in World Markets (1976), p. 7.



SOURCE: "OUTPUT PER HOUR, HOURLY COMPENSATION, AND UNIT LABOR COSTS IN MANUFACTURING, ELEVEN COUNTRIES, 1950–77," BUREAU OF LABOR STATISTICS, U.S. DEPARTMENT OF LABOR, MAY 4, 1978.

Figure 6. Output Per Hour in Manufacturing (Increase in Percent, 1950-76)

telephone call by 1970 was half its 1950 price, and (3) the price of a standardized calculation on a current model computer in 1977 was one percent of what it was in 1957.[6] Such sharp price reductions contribute to price stability by offsetting price rises elsewhere in the economy.

Innovation has also made American agriculture the most productive in the world. The American farmer now feeds 55 of his fellow countrymen compared to 7 in 1900. A substantial part of the gain in agricultural and food processing productivity has been achieved through intensive use of large-scale capital equipment, fossil fuel, and chemical based innovations. These innovations are mostly applicable to the larger farms, and small farms and food processing units have not received the attention warranted by their economic potential. Furthermore, the recent slowdown in agricultural productivity suggests that the traditional approaches have diminishing returns even for large farm operations. The inexorably rising costs of food in a hungry world, rising cost and uncertain availability of fossil fuels, the plateauing of major food crop productivity, growing scarcity of water, continuing high rate of soil erosion, and growing concern over quality of life indicate that innovation in agriculture is still urgently needed but with a redirection toward technologies that are less capital and fossil-fuel intensive and more conserving of other natural resources.

E. Innovation and New Problems

Today the economy is faced with challenges of achieving a better environment, renewing blighted inner cities, developing alternative sources of energy, and conserving energy and resources. Small innovative enterprises can play important roles in all of these areas, especially in rebuilding inner city communities.

With innovation, new opportunities and options become available for new, technically oriented, small businesses in revitalizing inner city communities. These include new types of building design, construction, and renovation; installation and maintenance of solar energy devices; urban farming and small-scale food processing; specialized computer-based education training centers; technology application centers; health care centers; and private delivery of welfare services. Widespread participation in small enterprises gives control to residents of the inner city and provides them the long-absent economic opportunity and incentives for success. Most importantly, urban revitalization that is based on diverse profitable enterprise rather than a host of public programs will provide a community the means of being self-sufficient and responsive to changing needs from within.

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[6]Data for 1 and 2 from Burton Klein, Dynamic Economics (Harvard University Press, 1977) pp. 130 and 138; for 3, Control Data price/performance records on central processing units.

F. The Unnoticed Crisis

By its nature a decline in innovativeness is not readily perceived. We do not see this crisis the way we see the urban decay or the lines at the employment office. But we think this unnoticed crisis underlies in large part our visible crises.

The Work Group believes that innovativeness in U.S. industry has declined substantially over the past decade. We also believe that an important factor in the decline is a series of difficulties besetting small, technically oriented firms. Because small firms have been found to have a much greater efficiency in innovation, a general decline in U.S. innovation could be expected if our small, technologically innovative businesses were to fall upon hard times.

Quantitative evidence corroborating this hypothesis is scarce, but support is contained in a study commissioned by the National Science Foundation and completed in 1975.[7] The study reported that in the 1953-73 period, about half of the major innovations produced in U.S. industry were made by firms with less than 1,000 employees and about one-quarter by firms with less than 100. Also reported in the study was a significantly sharper decline in the number of major innovations per sales dollar attributable to smaller firms (less than 100 employees) since 1967 than in larger ones (more than 1,000 employees): 33 1/3 percent compared to 21.1 percent. The decline in innovation has been accompanied by the virtual disappearance of seed venture capital to support the establishment and growth of small, technically oriented firms. (See Figure 7.)

This less visible crisis may contribute to some of the more visible problems - - the deficit in the balance of payments and weakening of the dollar, the productivity slowdown, and the devastating effects of stagflation on jobs, urban blight, and our standard of living - -all of which gives an urgency to the consideration of measures to reverse this decline, and to permit small, technically oriented firms to make again the contributions to the economy they achieved in the fifties and sixties. It is to these recommendations that we now turn.

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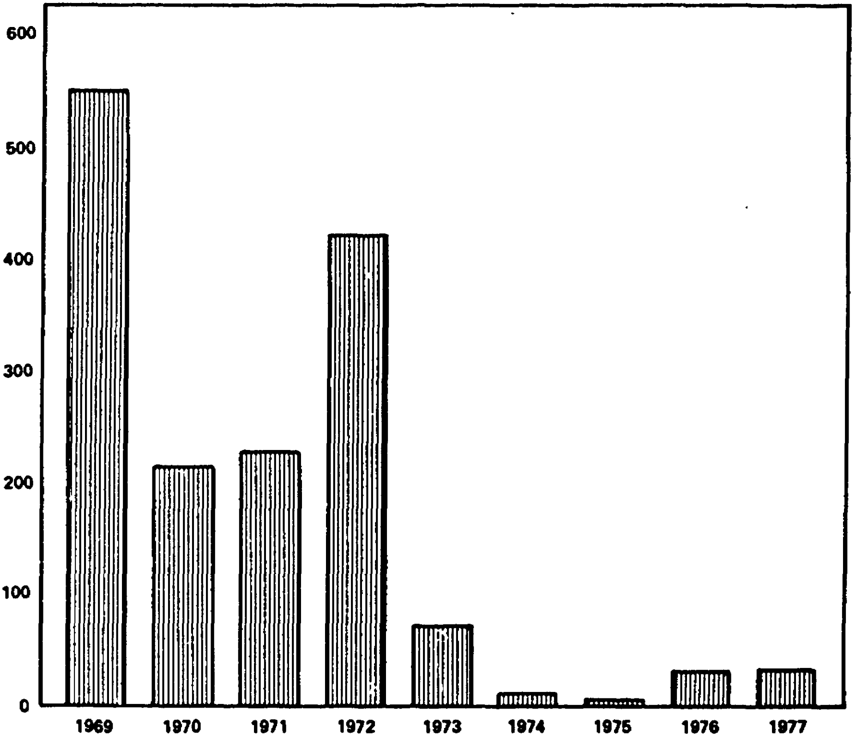
[7]William K. Scheirer, Small Firms and Federal R&D (Washington) p.9. See also Richard O. Zerbe, Jr., "Research and Development By Smaller Firms", Journal of Contemporary Business, Spring 1976.



SOURCE: REPORT OF THE SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL FOR SMALL BUSINESSES, U.S. SMALL BUSINESS ADMINISTRATION, JANUARY 1977, p. 13 (1969–75); GREYLOCK MANAGEMENT CORP. (1976–77).

Figure 7. Number of Small Company Public Issues, by Years

III. RECOMMENDATIONS FOR RESTORING AND ENHANCING THE VITALITY OF SMALL TECHNICALLY ORIENTED BUSINESSES

A. Increasing the Availability of Capital

Access to the public securities market for all business firms is controlled by regulations of the Securities and Exchange Commission. Full compliance with these regulations, which is necessary to protect the interests of investors, can be excessively burdensome to business firms, and especially so to small business firms. In recognition of this principle, the SEC created Regulation A, which facilitates small securities offerings by exempting them from the costly and time consuming requirements of full registration. Over time, the value of the exemption was reduced markedly because of inflation. The SEC has, however, recently raised its ceiling and also modified Regulations 144 and 146 so as to facilitate the sale of equities in small businesses by major stockholders. With these changes in securities regulation, the major barrier hindering access to the securities market by small businesses lies in the tax laws. It is to be hoped that the SEC will review its regulations on a regular basis and revise them periodically so as to minimize their adverse impact upon small businesses.

SEC regulations are one illustration of the way government policies shape the structure of capital markets. Actions of other government agencies also have an impact. We believe that the combined effect of policy changes over the past decade has served to place small companies at a disadvantage with respect to access to capital markets.

Policy changes have also made the climate for investment in small businesses more unpredictable. Small operations are inherently fraught with uncertainty, and abrupt changes in government policy compound these uncertainties, making investment in small businesses excessively risky.

We believe government policy must create a more favorable and predictable climate for small business investment. Towards this goal, we recommend five specific actions that reverse the trend of placing small businesses at a disadvantage in obtaining capital and key personnel.

1. Taxation of Capital Gains

Changes in capital gains taxation are probably more responsible than any other factor for the deterioration in technological entrepreneurship that has occurred in the United States during the last decade. Such changes successively have lowered after-tax returns for successful innovation to a level where now, technologically innovative firms no longer are able to attract adequate investment. The present level of capital gains taxation has become a critical constraint on the founding and expansion of small, technically oriented firms.

Engaging in industrial innovation is inherently risky because uncertainties of development of new technology are compounded by uncertainties of market acceptance of new products, processes, and services. At the same time innovation is a capital intensive activity, not because it requires such massive investment as steel and chemicals, but because of the time lag between launching a development and its large-scale market acceptance. Capital is required to cover the expenditures for start-up costs before revenue begins to be realized. Such capital is forthcoming only when potential investors believe that the after-tax returns will be adequate to cover the risks. The problem of adequate rewards, however, is not just one for capital; key management and technical personnel traditionally have been compensated for the personal risks in joining uncertain ventures by sharing in the fortunes of the firm rather than by salary payments. In our free enterprise system successful technical entrepreneurship creates the economic values. These, in turn, are reflected in the rise in stock prices of the enterprise and realized by investors and key individuals by the sale of their stock in such enterprises. Thus the after-tax capital gain is the critical incentive for technical innovation by small firms.

Since 1970, the tax on capital gains has increased dramatically. Prior to 1969, the maximum capital gains tax rate paid by individuals was 25 percent. The Tax Reform Act of 1969 increased that rate to a maximum of 40 percent -- a 35 percent rate on the capital gains themselves and an additional 5 percent possible from the operation of the minimum tax. Legislation also reduced the tax on earned income from a maximum rate of 70 percent to 50 percent.

Thus the differential between the taxation of salaries and capital gains narrowed from 70 percent on salaries and 25 percent on capital gains to 50 percent and 40 percent respectively.[8]

The Tax Reform Act of 1976 provided for further increases in the minimum tax and also raised the maximum rate on capital gains to 49.5 percent. These changes virtually eliminated the differential between the rates on earned income and capital gains. The effect of these changes was further compounded by a high rate of inflation which produced significant capital gains in current dollars, and hence capital gains taxes, for assets whose value after adjustment for inflation had actually declined. The impact of such changes in taxation has been dramatic for the small, technically oriented firms in which the prospect of capital gains has been the major incentive for investors. Therefore, we place the highest priority on a capital gains tax reduction targeted on small, technically oriented firms.

We consider such tax reduction a preferred method of improving the availability of capital to small, technically oriented firms. By increasing the rewards for successful ventures, an incentive is provided to manage such enterprises in an efficient way, leaving to the marketplace the distribution of the incentives among firms. Thus such an approach is preferable to the provision of loans or other federal financing to small firms, an approach that would thrust upon the federal government the difficult task of deciding among promising loan applicants. We recognize that our proposal might result in an initial revenue loss to the federal government, but given the narrowly limited target of the proposed tax reduction, it would be a minimal one, and losses would be offset by the gains in employment and output from these successful firms.[9]

The 95th Congress recognized the negative consequences of the present high rate of capital gains tax by passing significant rate reductions. The legislation, however, does not restore the 1969 rates. Given the risks of small, technically oriented businesses we consider such a rollback essential for these firms to realize their potential in such vital areas as job creation. We also consider essential an even lower rate of 10 percent to attract investment in the smallest of businesses -- for example, those with less than 100 employees. Application of the lower rate would be determined by the size of the businesses at the time the investment was made and thus serve to attract capital to

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[8] Tax Policy, Investment and Economic Growth (A Report by Securities Industry Association, 1978) p. 63.

[9] Michael K. Evans. The Economic Effects of Reducing Capital Gains Taxes. Chase Econometrics Associates, Inc., April 1978. See also Tax Policy, Investment and Economic Growth, pp. 34-7.

new firms and to recognize the higher risk of investment in the smallest firms. We would exclude from the rollback all real estate activity, because such transactions do not have as high a potential for job creation as investment in other small businesses.

Recommendation 1.

We recommend that the capital gains tax rate be reduced to 25 percent (the pre-1969 rate) on the capital gains realized from the sales of stocks of small businesses (less than 500 employees at date of purchase) whenever such stocks have been held for more than three years, with a rate of 10 percent for the capital gains of investors in the smallest businesses (less than 100 employees at date of purchase). These reduced rates would not apply to capital gains realized from the sale of real estate.

2. Tax-free Exchange of Stock

Continued investment even in successful, technically oriented, small firms whose stock has risen in value usually remains risky. Stockholders have a propensity to diversify their investment. Under present tax laws often the most profitable way to diversify is through merger with a large firm, carried out by a tax-free exchange of stock. Investors find that equity shares of large firms are likely to be more liquid and represent a diversified set of economic activities. Yet this method of diversification tends to concentrate capital in larger firms.

We consider it important instead to have tax policies that encourage the use of capital in the start-up of new firms. At the same time we recognize that that investor's desire for diversification of his risk is a legitimate one. Therefore we would like to establish an alternate route for tax-free diversification of risk that would encourage the formation and growth of small firms by allowing the tax-free rollover of investment in one small firm to another such firm.

We think such a provision -- similar to the rollover provision on sale of homes -- would make funds available to new, small, technically oriented firms, precisely from the most knowledgeable and receptive investors -- those that have already participated in such ventures. It would remove the tax incentive for the premature sale of successful firms to large firms and thus serve to retain at least some of them as independent business entities during their dynamic early stages of growth. Further, it would allow the investor to diversify by holding stock in several small, technically oriented firms.

Essentially the same proposal was made in 1976 by the Tax Policy Task Force of the Small Business Advisory Committee on Economic Policy.

Recommendation 2.

We recommend deferral of capital gains taxes on the sales of stock if the proceeds are reinvested within one year in small businesses, except those whose principal activities are real estate transactions.

3. Taxation of Corporate Income and Tax Treatment of Start-up Losses

Taxation of Corporate Income. Not only have small businesses experienced great difficulty in obtaining capital in their start-up period, but they continue to have trouble finding capital for financing expansion during their early years of existence. Although quantitative data are not readily available, capital shortage is believed to contribute significantly to the high failure rate of small businesses.

Causes of capital shortages in business firms range over a broad spectrum, but in the case of small young companies that are bringing new products or services to market, current tax rates on net earnings are so high as to preclude establishing a solid financial base that is attractive to investors. The best and easiest way for small firms to achieve a sound financial base and adequate funds to support expansion is, of course, through retained earnings. Current tax rates on corporate earnings are not, however, sufficiently differentiated between small firms and large established corporations, although the reductions made by the 95th Congress in the corporate tax structure were a step in the right direction. Before the 1978 reductions, net earnings by all companies, regardless of size and age, were subject to a tax of 20% on the first $25,000 of net income, 22% on the next $25,000, and 48% on income over that amount. In 1978, Congress lowered these rates to 17% on the first $25,000 of net income, 20% on the next $25,000, 30% on income between $50,000 and $75,000, 40% on income between $75,000 and $100,000, and 46% on income over $100,000. Most states also collect income tax on small businesses, and many in addition impose taxes on dividends to stockholders.[10] We believe small businesses would have better chances for survival and growth if the tax rates on net earnings were reduced further.

[10]Tax Review, Vol. XXXVIII, No. 12, December 1977, p. 47.

Tax Treatment of Start-up Losses. The established corporation is provided a tax incentive for innovation in that its expenses for the early phases of innovation are a deduction from its corporate income tax. The new firm cannot obtain the same tax benefit since it lacks profits from which losses can be deducted. Such losses can, however, be carried forward and charged against income in subsequent years, but only within a five-year period. Some of the most advanced and promising technology has a longer gestation period and so does not yield profits within this five-year span to which earlier losses can be offset. In such cases there is a tax bias against the smaller firm as compared to the large firm. We believe this tax bias should be eliminated.

Recommendation 3.

We recommend that the threshold for application of the full corporate tax rate of 46% be raised from $100,000 to $200,000 of annual net income; and for annual net income below $200,000 a progressive rate schedule beginning at 10% on the first $50,000, and increasing in 10% increments to $200,000 on each additional $50,000. In addition we recommend that the carry-forward provisions for start-up losses of small businesses be extended from five to ten years.

4. Qualified Stock Option Plan for Key Employees

Small, innovative companies depend upon stock incentives to attract and retain key employees because they cannot afford the high salaries paid by larger companies. Small companies tend to go through a growth cycle where, in the early stages, technical knowhow is the dominant skill required. In due course, commercial products or services are produced from this knowhow, but the number of customers is small. Later, as market opportunities expand and production grows, new requirements develop: how to manufacture and market products on a larger scale and how to organize and operate efficiently more complex activities. This stage requires managerial talents that are more likely to be found in larger firms than in smaller ones.

The problem, then, is how to attract experienced managers from larger companies. Prior to 1976 a widely used and successful incentive was an Incentive Stock Option, which allowed a key employee the following choice: If he chose not to be taxed in the year of grant on the then value of the stock, he could defer payment of tax from the exercise date of the option to the earlier of (1) the year of sale of the underlying stock or (2) ten years after the grant of the option. The Tax Reform Act of 1976

eliminated this option. Consequently, the current law unduly penalizes key employees of smaller companies who must sell optioned stock at the time of option exercise in order to pay the required tax, yet are unable to sell the stock obtained from exercising the option because of the limited or illiquid market for the stock.[11]

Recommendation 4.

We recommend restoration of the Qualified Stock Option Plan for Key Employees of small businesses.

5. Pension Fund Investment

Funds available for investment are increasingly under the control of institutional investors. Pension funds are a leading example, and their assets are now about $200 billion. The managers of such funds are subject to ERISA regulations, and a conservative interpretation of these regulations requires the fund managers to limit their equity investment to stocks of blue chip firms traded in large volumes on public exchanges. Amending ERISA regulations could open up a new source of funds for small, technically oriented firms. We find much merit in the recommendation of a 1976-77 Small Business Administration Task Force on Equity Finance that ERISA be amended in such a way as to increase the availability of capital to new, small, innovative firms without jeopardizing the safety of pension plan investments.[12]

Recommendation 5.

We recommend (1) that ERISA's prudent man standard be restated so that it is clearly applicable to the total portfolio of pension fund investments rather than individual investments, and (2) that pension fund managers explicitly be permitted to invest up to five percent of pension fund assets in small firms.

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[11]"A Program of Tax Revision Proposals to Enhance Capital Formation for Growth Businesses", National Venture Capital Association (NVCA), Washington, D.C. May 1, 1977, pp. 9-11. Also see pp. 34-36 of Technological Innovation: Its Environment and Management, U.S. Department of Commerce, Washington, D.C., 1967, sometimes referred to as the Charpie Report, for a discussion of the merits of liberalized stock options for small firms.

[12]Pages 14 and 15 of the cited report.

B. Reducing the Burden of Regulation

Small businesses, along with large businesses and non-profit institutions, have been burdened by the recent expansion of both federal and state regulations. Some of the recent regulations -- those for occupational safety and health and for environmental protection -- have impacted most businesses. Others -- those for food and drugs and auto safety -- have applied to specific industries. We understand the social concerns that led to such regulations, and we are aware that both federal and state governments are reviewing whether current regulations are the most cost-effective way of dealing with these societal problems. For example, the Interstate Commerce Commission is relaxing its rules against shippers with their own trucking operations to seek for-hire traffic to eliminate otherwise empty back-hauls. We also recognize that the balancing of social gains and economic losses in assessing regulation is a complex task, ill-suited to a work group focussing primarily on the job-creating potentials of innovations by small, technically oriented businesses.

We note, however, that innovations -- because they involve new products, services, and processes -- are likely to encounter considerable regulatory uncertainty.[13] Such uncertainty is particularly burdensome to small businesses because they lack the specialized staff of large businesses to cope with the regulatory maze. As a result the task of regulatory compliance is likely to fall upon the already over-committed line management of small businesses. Ultimately it reduces their competitiveness both in domestic and foreign markets. A partial solution lies in the creation of regulatory advisory services, themselves largely small profit-making businesses, which can develop computer data bases and an expertise for coping more effectively and efficiently with the complexity of government regulations than individual small businesses. Such a service can save the time of small business management and reduce the cost of compliance.

To encourage the formation of such firms as well as to recognize that even the services of advisory firms will only reduce, but not eliminate, the burden of regulatory compliance on small businesses, we consider it desirable that more than the deduction of the actual business expense be permitted for payment to regulatory advisory firms. Furthermore, as a matter of good government, we think the cost of regulatory compliance for small businesses should be highlighted in government decision making by a tax deduction that exceeds the actual expense.

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[13]George S. Lockwood, Founder and General Partner, Monterey Abalone Farms, "An Address to the Third Annual Colloquium or Research and Development Policy," American Association for the Advancement of Science, Washington, D.C., June 21, 1978.

Recommendation 6.

We recommend that small businesses be allowed to deduct twice their payments for regulatory advisory services related to compliance with federal, state, and local regulation.

C. Improving the Diffusion and Application of Technology

There exists in the United States an enormous volume of information and technology in the laboratories of universities, government, and business. Much of it lies dormant; little is transferred from one of these huge knowledge reservoirs to another, and even less from the reservoirs for transformation into new products and services that serve societal needs.[14] This is social waste: knowledge is one resource whose use by one individual does not preclude its use by another. And for individuals to rediscover what is already known is costly to both the individual and society. We lack well-defined programs to encourage the widespread use of existing technology. We propose such a program that focuses on both the public and private sectors and, as will be emphasized repeatedly, is vital to small business.

Diffusion of technology is particularly important because our nation's R&D efforts are so concentrated as to limit their application to only a few sectors of the economy. Besides important concentrations in federal laboratories and universities, the largest firms in our economy account for much of the organized industrial R&D, especially in the chemical, electronic, aeronautical, and pharmaceutical industries. Small business cannot afford self-sufficiency in technology, and our society can ill afford to let technolcgy lie idle.

1. Technology Transfers from Federally-Sponsored R&D

Universities. The present level of research effort is approximately $5 billion -- nearly 70 percent of which is financed by the federal government.[15]

The main reasons for the small amount of technology flowing into industry include lack of:

1. Well-defined programs and funds to implement technology transfer.

2. Incentives for faculty researchers to seek beneficial commercial applications for research results and to participate in technology transfer programs through personal linkages with users in industry.

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[14]Russel L. Ackoff and others, Designing a National Scientific and Technological Communication System, University of Pennsylvania Press, 1976, pp. 109-153.

[15]National Science Foundation, National Patterns of R&D Resources, National Science Foundation 77-310, pp. 10 and 23.

3. Attention to needs of industry.

4. A positive government patent policy that stimulates private industry to commercialize inventions by transferring rights instead of retaining patent rights in most cases.[16]

Through the establishment of a well-defined technology transfer program, technology flow into small business can be substantially increased. One important element is commercially available, computer-based information storage and communication systems. Massive amounts of information can be stored in the computer memory and quickly recalled. By including two types of information in the data bases -- one consisting of descriptions of technologies in terms that show prospective buyers the kinds of problems the technologies will solve, and the other describing the problems that are to be solved -- interaction can be facilitated between providers and users of technology.

Specifically, when an idea for innovative technology occurs to a scientist during the course of a university research project, he lists it with a commercial, computer-based communications technology data base service. Conversely, those seeking innovations use the same service to obtain information about technologies that may satisfy their needs. This interaction not only greatly increases the chances that the idea will be used, but more importantly it makes innovation possible in response to a combination of market pull and technology push instead of just technology push. Experience teaches that the most successful and least costly innovations are those where there was early linkage between the idea and the needs of the marketplace, because the development could be properly guided through interaction between researchers and users.

Funding for technology transfer programs should be included as part of each government research project grant. The amount recommended is five percent of the total project funding, a small amount in relation to the expected benefit to society.

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[16] Remedies for this serious deficiency were not addressed by this Work Group because it is being addressed by the Committee on Intellectual Property and Information, which was established by the Federal Coordinating Council for Science, Engineering, and Technology. The Committee is in the midst of an effort to arrive at an agreed Carter Administration policy with respect to the allocation of rights in patentable inventions resulting from federally-supported work done by nongovernmental persons. The Committee is chaired by Dr. Jordan J. Baruch, the Assistant Secretary of Commerce for Science and Technology. Its efforts are separate from, but to be coordinated with, the Domestic Policy Review on Industrial Innovation.

Within the university there should be a small administrative organization to help market the ideas for innovative technology. Royalties paid by industry should be divided among the university (to help defray administrative costs), the scientists originating the ideas, and those who are key in helping to find industrial uses.

Another way to encourage closer relationships between small businesses and universities is through having small businesses sponsor the research at universities just as large firms do presently. Such sponsorship could be expanded by allowing small businesses a double deduction from its income taxes.

Government Laboratories. The situation in government laboratories is much like that in universities. A key statistic is that the federal government spends over $1 billion annually to disseminate results of federally-funded R&D.[17] Yet it is frequently impossible or extremely difficult for either government or industry to get these results. Reasons for this are essentially the same as those listed for universities.

The government agency with the largest R&D budget and least effectiveness in technology diffusion is the Department of Defense. The low level of success is due to almost total reliance on documents produced by research and development projects as the means of transfer. Other government agencies relying solely on documents have the same low level of results.

NASA, through its technology utilization program, has made a greater and more diverse effort since 1962 to transfer its research results into commercial use. In addition to the dissemination of publications, NASA has established industrial applications centers that assist industry in acquiring information on NASA technologies. While the NASA program falls far short of what might be achieved, more technology is moved into industry than would be the case without the program.

The largest and most successful federal effort to diffuse technology has been the Extension Service of the Department of Agriculture. USDA field agents working at the county level throughout the United States and drawing from the Department of Agriculture sponsored research results make direct contact with individual farmers.

A final observation to be made on government and university technology transfer activities is that in all cases the process begins after the research and development program has been completed. As noted earlier, however, the most successful industrial innovations are those where there was an early linkage between the idea and the marketplace, so that the development can be properly guided.

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[17]See "Federal Management of Scientific and Technical Information (STINFO)" prepared for the Special Subcommittee on the National Science Foundation of the Committee on Labor and Public Welfare, U.S. Senate, February 1976, pp. 9-10.

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We believe that there must be a change from the traditional and ineffective practice by most agencies of merely disseminating information as a means of technology transfer to the more comprehensive approach that has been outlined. Funding for implementing the comprehensive approach for technology transfer should be included as part of every government project -- five percent of the total project funds -- the same as for university projects. For comparison purposes, it should be noted that the U.S. Department of Agriculture Extension Service budget of $270 million is about 50 percent as large as the department's R&D budget of $500 million, and the NASA technology utilization budget is $9 million, or about 0.3 percent of the NASA R&D budget.

Therefore, our proposals focus on facilitating the transfer of technology from the concentrations in government laboratories, universities, and industry to small businesses, where it can often be applied to realize a larger share of its economic potential.

Recommendation 7.

We recommend that each federal agency allocate five percent of its R&D funds for technology transfer. These funds should be used to establish well defined and organized programs of technology transfer in which there are incentives to individual researchers to contribute their time and skills to the identification of commercial applications. Such incentives should be related to the benefits realized from technology transfer.

2. Technology Transfers Within the Private Sector

Another large store of under-utilized technology exists in business firms. Most firms use only part of their stock of technology in their own commercial activities, but the remaining, unused technology may have commercial applications elsewhere in our economy. Even more importantly, firms utilize technology in one product that may have applications to other products. Interfirm transfer of technology is constrained, however, by concern for proprietary protection. Much of this concern is unwarranted because even in the few areas of significant technological breakthroughs in recent years, the new technology was diffused so rapidly that any initial business advantage was soon lost. Thus, in most industries, a number of companies are selling the same basic product, differentiation being achieved by design features to improve user application and appearance. Hence, much of the technology of one firm can be used by others with little competitive threat. Given the benefits to society from increased technology transfer and in recognition of the added costs of marketing technology, we recommend that both financial and social incentives be used to stimulate large companies to make their technology available to small companies.

Financial Incentives. The most frequent method of transfer is through a licensing arrangement. Another way in which technology transfer occurs is through the spin-off of small businesses by large firms. We believe that such spin-offs will be encouraged by the capital gains rollback for small business as set forth in our first recommendation.

A large firm can use technology unrelated to its main activity as the basis for establishing a small business in which it takes a minority position. Its capital gains would be taxed at the lower small business rate just as for any other investor.

Both licensing and spin-offs need to be supplemented by greater incentives for business firms, large and small, to participate more actively in technology transfers, and these can be provided by changes in the tax code. It must be recognized that such transfers are costly, and both buyers and sellers must be able to perceive at least some chance that their costs for transferring their unused technology will be covered. Further, if they perceive the possibility of greater profit, their interest in transfer will be correspondingly greater.

Social Incentives: Social incentive would be provided by the community in the form of a consensus that large companies should make their technologies more available as part of their obligation to society. This is a reasonable gesture by any company, because all technology is in part a product of our educational system and diffusion of knowledge from the technical efforts of other organizations.

Recommendation 8.

We recommend that private sector individual or corporate owners of technology be rewarded, through appropriate changes in the tax code, for selling, leasing, or licensing their technology to small business firms in the United States. In addition, we recommend the establishment of a voluntary national policy to encourage companies to make their technologies available for noncompetitive uses by others.

D. Some Redirection of R&D Spending Towards Small Businesses and the Needs of Small Family Farms and Food Processors

While there has been widespread comment on the decline of U.S. R&D expenditures as a percent of our Gross National Product, this same trend has in recent years also occurred in such countries as France, the United Kingdom, and West Germany; the notable exception being Japan (See Table 1). The United States remains by far the largest money spender on R&D even if defense and space spending is excluded (See Table 2).

The Work Group does not contend that R&D spending in the U.S., in total or in the amount devoted to civilian needs, is either demonstrably deficient or excessive. We

do contend, however, that the amount spent by small firms is grossly inadequate. In 1975 only about three percent of our total national spending on R&D -- roughly $1 billion out of $35 billion -- was attributable to small firms. Funds from the federal government accounted for about two-thirds of this total -- the balance from small businesses themselves.[18] While this small proportion has prevailed for some time, we consider it disturbingly low in view of the impressive record of innovation by small businesses.

Table 1. Distribution of National R&D Expenditures in Selected Industrially Advanced Countries as a Percentage of GNP, 1961, 1967, 1972, and 1975.

	1961	1967	1972	1975
United States	2.74	2.91	2.43	2.32
Canada	1.01	1.33	1.17	1.20[E]
France	1.38	2.16	1.83	1.48
Japan	1.45[E]	1.55	1.89	2.00[E]
United Kingdom	2.69	2.69	2.39	2.25[E]
West Germany	1.20[E]	1.97	2.31	2.25

Source: National Science Foundation. Science Indicators 1976, p. 184, except estimates, as noted.

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[18] Scheirer, op. cit., p. 16.

Table 2. Estimated R&D Expenditures for Civil Purposes, 1975

(In billions of dollars)

	Canada	France	Japan	U.K.	West Germany	U.S.
1. GNP ($)	152	338	493	229	425	1516
2. % R&D	1.2	1.48	2.0	2.25	2.25	2.32
3. R&D ($)	1.8	5.0	9.86	5.15	10.6	35.2
4. % R&D in Space and National Defense	5.3	26.2	1.7	24.5	8.1	34.4
5. % R&D in Civilian Programs	94.7	73.8	98.3	75.5	91.9	65.6
6. R&D in Civilian Programs ($)	1.7	3.7	9.7	3.9	9.7	23.1

Sources: Row 1. World Military and Social Expenditures 1978, pp. 21-2.
Row 2. Table 2.
Row 3. Product of Rows 1 and 2.
Row 4. National Science Foundation. Science Indicators 1976, pp. 186-7.
Row 5. 100% minus Row 4.
Row 6. Product of Rows 3 and 5.

As seen by the Work Group, one of our principal problems is how to increase R&D in small business firms. Since there have been important innovations created by cooperative work between large and small businesses, we would include such cooperation in our concern to increase the share of federal R&D funds to small business firms.

The Work Group is aware of a recommendation made some years ago (1972) by a Commission on Government Procurement to the effect that awarding a fixed percentage of government procurement to small business firms is not in the national interest. While this may be a valid constraint insofar as all government procurement is concerned, we do not believe it should apply to federal R&D funds. The outstanding track record of small business in technological innovation is ample justification for assuring that R&D activity in small business firms be stimulated through increasing its share of federal spending on R&D. We recognize that in certain basic research programs, the commercial sector may be an inappropriate institution for R&D. We believe, however, that applied research projects jointly involving small businesses and universities can be highly effective, and we recommend that a substantial number of these be sponsored by the government.

The Work Group believes the National Science Foundation's program called "Small Business Innovation Applied to National Needs" has great potential for increasing technological innovation in the private sector and is worthy of emulation or even adoption by other federal agencies. By soliciting innovative proposals from small businesses, the program encourages the conversion of research on federal objectives to technological innovation in the private sector. This is done by requesting a contingent commitment for follow-on funding from a venture capital or large business source for continued development of the idea by the small firm if the research meets mutually agreed upon objectives.

Recommendation 9.

We recommend that each federal agency receiving R&D funds by appropriation from the Congress be required to allocate at least 10 percent of all such funds (excluding those for basic research) to small businesses and that this objective be achieved in annual 1% increments beginning in FY1980.

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Small business firms that invest substantial amounts of their own funds in R&D are subject to risks of temporary reversals that jeopardize the stability of R&D spending, which is often less critical in the short run than other uses of funds. Yet by reducing or eliminating R&D, the small firm may endanger its future and the continued development of new products and services necessary for its longer term growth and survival. Collectively the problem inhibits the growth of small innovative firms as a national resource.

Stability in R&D activity in small firms would be encouraged if such firms were allowed to establish and replenish a Reserve for Research and Development in better profit years to be used to stabilize R&D in lower profit or loss years. The reserve would allow the firm to retain more earnings, which is important to firms seeking credit and investment.

The reserve would not be available to firms that could not generate earnings, but rather would assist those firms that have proved their competence by profitable operations. These are the firms that need encouragement to grow faster and to invest in R&D and to stabilize R&D programs.

The reserve could be accumulated to a level of $100,000 or 10 percent of the most recent year's sales, whichever is higher, up to a $1 million ceiling. Contributions to the reserve could only be made to the extent that actual R&D costs are incurred in any year and limited to the higher of $50,000 or 5 percent of sales for any single year. Any use of the reserve for R&D would be taxable just as contributions to it are tax deductible. If the firm became a large business through growth, or merger or acquisition by another small firm, the reserve could be used but not replenished. Acquisition by a large firm would result in the reserve becoming taxable income.

Recommendation 10.

We recommend that small business firms be allowed to establish and maintain a reserve for R&D for use in times of financial stress.

* * *

More must be done in addressing the steeply rising costs of food throughout our country. Obviously, many factors contribute to these increases, but one of the most important is the plateauing of productivity in major food crops. Per acre yields of wheat, sorghum, maize, soybeans, and potatoes have not increased since 1970. A significant part of the previous increases in productivity was accomplished with massive use of fossil fuels for cultivation, irrigation power, fertilizer, and pesticides. Costs of all of these are rising rapidly. Water shortages in a number of areas of the United States have occurred or are imminent. Productivity gains of the past have been associated with large-scale capital and fossil-fuel intensive agriculture. There is vast potential for improvement with innovations directed at developing less fossil-fuel and capital-intensive technologies, and technologies that make more efficient use of water and land. Research directed at creating these technologies would benefit both large and small farm operations.

Small farms also are part of America's poverty problem. The conditions for many people, particularly blacks in rural areas in the South, are worse than in blighted urban areas.

The key element in improving the efficiency of small farms is technology. Capital, government policy, and other factors are important; but without technology appropriate to the task, capital and government policy cannot have the required effect.

Further substantiation of the potential of more emphasis on small-scale operations is provided by a brief review of some relevant current achievements, experiments, and emerging technologies.

●●●The Ball Company is marketing an energy-efficient canning operation that fits into 750 square feet of space.

●●●Solar technologies are emerging that make small-scale grain drying and storage more efficient than present methods, and provide a lower cost source of power for irrigation.

●●●The development of small-scale sprinkler irrigation systems is nearing completion. Indications are that these systems will provide a 15 percent savings in energy and as much as a 20 percent savings of water.

●●●New, stronger, weather-resistant plastics are becoming available, which makes possible low-cost, small-scale hydroponic food growing and the manufacturing of small-scale methane gas generators.

●●●Farm-size nitrogen fertilizer plants using air, water, and electricity from windmills are under development.

●●●Multi-purpose, small scale farm tilling and harvesting implements are becoming available.

●●●Farm management training for diversified small-scale operations are now readily available through computer-based education.

●●●One of the most significant experiments under way is the model farm at Tuskegee Institute, where an income of $20,000 net per year is to be generated by a farm of 25 acres, of diversified high-value crops and other intensive agricultural technologies.

. . .

These examples demonstrate that new technologies can be developed to enhance significantly the productivity of small family farms and food processors with reduced requirements for capital and fossil fuels. With additional R&D effort, the viability of small farms over a wide range of conditions could be established. Furthermore, many of these kinds of small farm technologies are needed by developing countries and represent an important source of exports in the years ahead.

Recommendation 11.

We recommend that there be some redirection of federally supported agricultural research to the development of technology for improving the efficiency of small family farms and food processors and for making food production, transportation, and preservation less capital and fossil-fuel intensive.

E. Improving Export Performance

Much has been written about the fact that among industrially advanced countries, the United States is the least export minded. This can be discerned from the fact that less than eight percent of U.S. manufacturers export (perhaps 20,000 out of some 250,000 manufacturing companies). Moreover, the U.S. export base is highly concentrated: a recent survey conducted by Business International Corporation discovered that 123 firms accounted for 41 percent of U.S. exports of manufactured goods in 1976.[16]

There are several explanations for the low rate of participation of small firms in exporting activity. First, they lack the knowhow to find and penetrate export markets. Such knowhow can, of course, be bought or acquired through experience, but it is expensive. Second, profit margins in international markets have not, until recently, been sufficiently high to attract a large number of small firms. The currency devaluations earlier in this decade have shifted the terms of trade to such an extent that exporting could well become a highly profitable activity for many small firms.

For this development to occur to any important extent, two kinds of measures are needed. One is institutional: a new private sector organization should be created to enable small firms to reach export markets on a shared-cost basis. The second is financial: special tax incentives are required to encourage small firms to overcome the initial costs of entering export markets. Once threshold barriers are overcome, the profitability of exporting can be expected to sustain the growth of exports from small, technologically based firms. Such exports would strengthen our balance of payments while simultaneously providing for the growth of small firms through opening new markets.

With respect to new organizations, we consider the most promising to be Small Business Export Trade Corporations (SBETC) -- private corporations to provide marketing services to a group of small firms. An SBETC must serve at least three clients who are small business firms, and its primary activity must be export promotion for small business. To encourage their formation, these organizations need special tax incentives.

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[16] "Effects of U.S. Corporate Foreign Investment, 1970-76," Business International Corporation, May 1978.

With respect to individual small businesses, we consider that significant tax incentives are needed to encourage the incurring of the initial special costs of entry into export markets. These include sales literature, sample advertising, trade fair participation, special engineering and tooling, new equipment, reserves for bad debts, and so forth. The special tax incentives as described are believed to be consonant with U.S. commitments to the General Agreement on Tariffs and Trade (GATT). If necessary, the proposed upper limits could be further constrained so as to prohibit a net rebate of income taxes to the participating firms.

Recommendation 12.

We recommend that the creation of Small Business Export Trade Corporations be encouraged by a double deduction for these corporations of up to $100,000 of annual expenses associated with the exporting activities of each client, with a loss carry-forward of ten years. In addition, we recommend that small businesses be allowed a double deduction of special expenses of serving export markets up to $100,000 annually.

IV. CONCLUSION

More new jobs, especially skilled jobs; better solutions to our national problems of urban decay, pollution, steeply rising costs of food and housing, and health care; and increased competitiveness in international markets, all depend upon our ability to stimulate the rate of technological innovation in the United States. Small businesses can play a significant role in achieving this goal.

The recommendations contained in this report are directed at restoring the vigor and vitality of our small businesses, which traditionally have generated the larger share of the truly innovative breakthroughs in science, technology, and engineering. Ways have been identified to increase the supply of venture capital, without which new businesses cannot get established, much less flourish. Some redirection of government R&D spending is recommended to channel more funds into R&D effort that is most likely to benefit small businesses and small family farms.

Recommendations are made for not only increasing the supply of new technology, but also for stimulating the transfer of technology from federally funded R&D projects to the private sector and from large business firms to small ones. Concrete proposals are offered for expanding exports and for reducing the heavy costs of compliance with government regulations.

Our recommendations do not call for federal aid to small businesses and small farms. On the contrary, implementation of all of the recommendations of this report, or of any one of them, does not require any increase in budgetary support from the federal government.

In addition to our 12 recommendations, we urge the Department of Commerce to encourage the creation of "Community Cooperation Offices", which foster the start-up and growth of small businesses. A Community Cooperation Office is a nonprofit corporation supported by private contributions. The major segments of society are participants, including state and local governments, large and small business, academia, religious organizations, labor unions, and farm organizations.

The Community Cooperation Office assists small businesses in getting started by providing seed capital and in profitable growth by furnishing assistance in locating needed technology and consulting help. Cooperation Offices should be informally linked with the Department of Commerce so that their experiences and concerns can be most effectively shared. The Minnesota Cooperation Office for Small Business represents a possible prototype for consideration by other states.

Finally, we urge the Department of Commerce to undertake the education of the American public as to the importance of technological innovation in creating solutions to our major social problems, and to the vital role of small business firms in the innovation process.

APPENDIX

Biographic Summaries of Work Group Members

WILLIAM C. NORRIS, Chairman
B.S.E.E., University of Nebraska; Founder, Chairman of the Board, and Chief Executive Officer, Control Data Corporation; Founder, Engineering Research Associates; former Vice President, Sperry Univac.

SHERMAN R. ABRAHAMSON, Executive Secretary
Ph.D. (Geography), Clark University; Special Assistant to the Chief Executive Officer, Control Data Corporation; former Office Director, U.S. Department of Commerce; former Visiting Scholar and Special Auditor in Economics, Harvard University; former Professional Lecturer in Geography, Economics, and Business Administration, George Washington University.

JOHN H. CARTER
Ph.D. (Physical Chemistry), University of Oregon; Director, Semiconductor Materials Products, IBM; Member, Commerce Technical Advisory Board; Member, Board of Directors, Communications Village, Inc., Kingston, New York; Consultant, Harvard University Institute for Minority Business Enterprises, and Urban Business Education and Economic Development Association of Washington, D.C.

DONALD W. COLLIER
Ph.D. (Physical Chemistry), Princeton University; Senior Vice President, Borg-Warner Corporation; Member, National Research Council and Commerce Technical Advisory Board; Fellow, American Institute of Chemical Engineers; former President, Thomas A. Edison Research Laboratory; and former President, Industrial Research Institute, Inc.

WILLIS K. DRAKE
B.S.A.E., Purdue University; Founder and Chief Executive Officer, Data Card Corporation; Director, Riede Systems, Inc., Teleproducts Corporation, and APCO Capital Corporation; Chairman, Executive Committee, Industry Advisory Council, Institute of Technology, University of Minnesota; former Group Vice President, Data Products Corporation.

JOHN FREIVALDS
M.A. (Development Economics), George Washington University; Manager, Agricultural Projects, Experience, Inc.; former U.S. Peace Corps manager of farm cooperatives in Panama and Colombia; former Economist, Development and Resources Corporation, State of California; former Assistant to the President, I.S. Joseph Company, Minneapolis.

DANIEL S. GREGORY
M.B.A., Harvard University Business School; Chairman of the Board and Chief Executive Officer, Greylock Management Corporation; Director, Teradyne Corporation, National Venture Capital Association, and others; Trustee, Institute of Contemporary Art and the New England Medical Center.

VERNON H. HEATH
B.B.A., University of Minnesota; Co-founder and President, Rosemount, Inc.; Director, Tonka Corporation, First Trust Company of St. Paul, Abbott-Northwestern Hospital, and others; former Chairman, Board of Directors, American Rehabilitation Foundation (Sister Kenny Institute).

HERBERT C. JOHNSON
B.S.M.E., University of Colorado; Chief Executive Officer, Electro/General Corporation; Founder and former Chairman of the Board and Chief Executive Officer, MTS Systems Corporation; Director, Tonka Corporation; former Chairman of the Executive Committee and Current Member of the Industry Advisory Council, Institute of Technology, University of Minnesota.

RICHARD S. MORSE
S.B. (Engineering), Massachusetts Institute of Technology; Industry Consultant and Director, Dresser Industries, Inc., Compugraphic Corporation, Scientific Energy Systems Corporation, and others; Founder and former President, National Research Corporation; former Assistant Secretary of the Army (R&D); former Senior Lecturer at the Sloan School of Management, M.I.T.

MARILYN NELSON
M.A. (Economics), Smith College; Chairman, Citizens State Bank of Waterville, Minnesota; Director, Northwestern Bell Telephone Company, Carlson Companies, Tyrone Guthrie Theater, Minnesota Orchestral Association, and others; Trustee, Macalester College and Member, Development Council, Smith College.

MERTON J. PECK
Ph.D. (Economics), Harvard University; Chairman, Department of Economics, Yale University; former Member, President's Council of Economic Advisers; former Director, Systems Analysis, U.S. Department of Defense.

NEIL SHERBURNE
Studied at Kansas State College and University of Minnesota; Member, U.S. Department of Labor Executive Reserve and Regional Manpower Advisory Board; Member and former Chairman, Board of Regents, University of Minnesota; former Secretary-Treasurer, Minnesota AFL-CIO.

ROBERT TAPP
Ph.D. (Religion), University of Southern California; Chairman, Humanities Program and Professor of Religious Studies, University of Minnesota; former Professor of Philosophy of Religion, Meadville/Lombard Theological School; former Managing Editor, Zygon: Journal of Religion and Science.

Mr. BEST. We are not, at this time, in a position to provide you with a cost-benefit analysis of the proposals that are before you. My own judgment is that the proposals are modest, and cost effective.

I would hope for a bolder program to send the signal across America to export now. We will, Mr. Chairman, ask all of the tax and economic experts and the members of our organization to give you their views on what should go into a comprehensive package.

The fundamental problem with the modest or bold approach, is that the administration, as pointed out by their witness today, appears to believe that there is no problem, or, at best, they underestimate the magnitude of the trade problem.

I am tempted to believe that some of the economic theorists in the administration feel that trade deficits are good, that they keep the rest of the world afloat. They reason that if we ended the deficits the poor developing nations would go under.

I really believe that it is this attitude which underlies the refusal to do anything positive to encourage exports and in fact to take actions, administrative and regulatory, to discourage exports. Our problem is not only foreign competitors and their barriers, but our own attitudes and actions. We constantly subvert a tough realistic trade program to tax theory or foreign policy considerations.

These theorists are wrong. We cannot resolve the world oil deficit problem by continuing to run U.S. deficits to finance some developing countries mounting debt to other developing countries. By doing that, we erode the value of the dollar, lead to greater OPEC price ripoffs and further damage the developing countries and ourselves.

Moreover, our deficits are not the surpluses of the poor developing countries; they are with the rich industrialized countries and with OPEC.

If the present trade deficits persist for another year or two, we believe our Nation's currency will be persona non grata; that the protectionism all the high theorists fear will indeed occur, and a massive economic earthquake will indeed occur, and a massive economic earthquake will ensue.

Perhaps that sounds alarmist, but these are not ordinary times. The prestigious Bank for International Settlements sometimes referred to as the central bank's central banker recently issued an annual report which stated: "A loss of confidence in the dollar due to a large current account deficit is likely to lead to a disorderly and excessive depreciation, fueling inflation in the United States and causing excessive appreciations elsewhere—not to mention its impact on the prices of oil and other commodities."

On Saturday, June 9, the Congressional Budget Office warned Congress to expect a full-fledged recession this year and through most of 1980.

The warning signals are there but the administration appears to ignore them. Never in my lifetime has the international economic, and political, system appeared so fragile.

The President recently appointed a disinguished group of Americans to an Export Council, including Hon. Mark Shepherd. It is nice to have an Export Council, especially of 40 Americans, but we did not have the luxury to study the problem to death.

I only wish we could develop a positive and meaningful program. It took almost a year to appoint a council. How long do you think it will take 40 people to agree on a program, when they meet but several times a year, even though they would be capable and well intended.

Mr. Chairman, I have one more page of my statement. I will defer to your wishes.

I could read it, or answer your questions.

Senator BYRD. It is getting a little late. Unless it is something special you want to bring out——

Mr. BEST. I would suggest, Mr. Chairman, that the committee request the Export Council for its views on the proposals before you, and that you request the views of Bob Strauss, Frank Weil and John Moore, all of whom have been making speeches for the last 3 years on the urgency of coming up with an export program.

I doubt that these men, who are dedicated to the Nation, would oppose a meaningful program, as was done this morning by Mr. Sunley.

Senator BYRD. Thank you, Mr. Best.

Senator Bentsen?

Senator Bentsen: Thank you very much, Mr. Best.

Mr. Best, I totally agree that we have to have an export policy. The goal of MTN, which this committee has helped formulate, is to try to get rid of inequities in international trade, to encourage international trade. We should not think for a minute that our competitors will not be trying to give their exporters a competitive edge if they can.

Business Week states that the United States must look out for its exporters and push their interests in every way it can. If this country does not claim its fair share of expanding world markets, it can be sure that aggressive exporters from Europe and Japan will.

On that same point, Ambassador Strauss said the MTN is only a first immediate, necessary step that will enable us to solve the problems over the next 5 to 10 years. We have got to develop an export thrust. I totally agree with that statement.

This question of the analysis of Treasury estimates on taxes, I have been there—so have you—under both Republican and Democratic administrations. I can recall when I proposed a particular tax cut and was given a horrendous estimate of what it would cost. The next year the Secretary of the Treasury proposed it, and they had a new estimate, and all of a sudden it made money.

So these static analyses can be turned in other directions.

I understand Mr. Sunley's problem when he was talking here and the various others were asking what policy the administration has on depreciation. There apparently is a debate going on in the administration.

I quoted from the financial section of the New York Times this morning that Treasury is arguing for more rapid depreciation to build up the supply side of the economy to check inflation. I totally agree.

But I do say, those not agreeing with them and trying to override the policy, that I think there is a strong feeling in this committee

and in this Congress to do those things to spur exports from our country through tax policy.

Unless we will take bold steps, unless the administration does, they are going to see the ball taken away from them again, just as it was on capital gains, where you are now seeing more risk capital available than we have had in 10 to 15 years in this country as a result of what happened on capital gains.

So I urge the administration to come forth with a bold program to encourage exports and to do the things to increase productivity in this country.

Thank you very much.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. I have no questions.

Senator BYRD. Senator Danforth?

Senator DANFORTH. The only thing I would ask Mr. Best to do is just to repeat his statement. It was excellent. However, I will not do that in the name of saving time.

Thank you very much for your comments.

Senator BYRD. Senator Long?

Senator LONG. I enjoyed the statement very much. If I started asking questions, I would be lengthening this hearing. I appreciate your statement. It was very good.

Senator BYRD. Thank you, Mr. Best.

[The prepared statement of Mr. Best follows:]

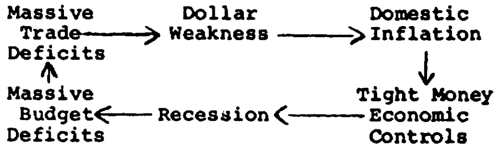
Statement of Robert A. Best, Executive Vice President, American League for Exports & Security Assistance, Inc.

Mr. Chairman, members of the Subcommittee on Taxation and Debt Management, we welcome this opportunity to provide our views on the need for a positive export trade program.

The American League for Exports and Security Assistance is a unique labor-management organization. Founded in 1977, it has as its charter and principal goal the development and implementation of policies to encourage American exports. The thirty-four corporations, employing over 800,000 workers, and the four international unions, representing 4.1 million American workers, in the ALESA membership firmly believe that the United States needs to adopt a national policy that encourages the production and export of American-made goods and services if we are to achieve the goals of (1) full employment; (2) price stability; and, (3) preserving the integrity of the dollar.

We are delighted that Members of this Committee have taken initiatives to encourage U. S. exports. We only hope the Congress as a whole and the Administration would see the critical importance of exports to our economy.

The economic strength of this nation is rapidly being eroded by the vicious cycle of:



Mr. Chairman, we don't have all the answers but we do strongly believe that we cannot continue for very long to permit the vicious cycle described above to persist.

We do know that:

-- every billion dollars worth of exports create 40,000 to 50,000 jobs

-- every 1 million jobs creates in taxes (corporate and individual) $22 billion in revenue to the U. S. Treasury

Those are estimates of the Congressional Budget Office used by Majority Leader Jim Wright. Assistant Secretary of the Treasury, C. Fred Bergsten, has used even greater estimates of the job and income creating effects of exports in his speeches.

Given the multiplier and feedback effects of exports on jobs, income and revenue, if we only increased the ratio of exports to GNP by 1 or 2 percentage points we would eliminate the fiscal deficits and gainfully employ another 1.6 million Americans. That's the best human rights program for American workers and investors I can think of.

The issue therefore is exactly what you, Mr. Chairman, indicated in your press release. The issue is not whether we can afford to have a positive export policy; the issue is whether we as a nation can afford not to have one.

We strongly believe that America's greatest long-term strength -- our industrial base -- depends importantly on the high technology sector where we have maintained our only competitive advantage. This in itself becomes an ever

increasingly important factor in our overall long-term national interest.

Across America, there is the growing sense that we as a nation are falling behind in the competitive race, that our spirit of innovation is gone, that we have become an over-regulated, welfarized, lethargic, and divided nation incapable of coming to grips with our problems.

There has been in recent years, a dangerous erosion in the ability of U. S. industry -- particularly high technology industry -- to compete in the world marketplace. A major reason has been the anti-export policies of the government which inhibit and discourage exports through laws, licensing procedures, regulations, and other disincentives. In contrast to U. S. policy, other major industrial nations have developed positive export programs to provide jobs in the private sector through domestic production for export and to earn through exports the foreign exchange needed to pay for energy imports.

One has only to compare the $39.6 billion deficit (cif basis) of the United States with the $20.3 billion surplus (cif basis) of Germany and the $18.3 billion surplus (cif basis) of Japan to recognize that those countries -- despite the appreciation of their currencies, despite their 80-95 per cent dependence on imported energy -- have overcome external problems and maintained high levels of employment and, particularly in Germany's case, relative price stability. Germany and Japan have surpassed the United States as the leading exporter of manufactured products. They beat our brains out in

competition while we generously spend billions to defend their freedom. While we should defend freedom we cannot do it with a weak domestic economy or a continuous decline in our competitiveness. These facts underscore the critical importance of a positive export policy for security as well as domestic economic reasons.

Mr. Chairman, the domestic budget cannot be balanced as long as our nation maintains a passive approach to exports and permits the stagflationary effects of massive trade deficits. Why? Trade deficits of the magnitudes we have experienced severely weaken the dollar; drive up the costs of imports (including energy) thereby inducing inflation which leads either to controls or recessions or both thus creating further domestic budget deficits. As long as the economy remains weakened by the stagflation it will be impossible to balance the Federal budget.

The massive inflation-inducing trade deficits are symptomatic of a deeper problem than the simple line heard frequently by Administration officials, paraphrased as follows: "if we didn't import $50 billion in oil each year, we would be in great shape." That is the reasoning of a defeated and/or bankrupt policy, not a positive, aggressive approach. It's really more of an excuse for a laissez faire approach to the inflation-inducing effects of structural trade deficits. When you don't really want to solve the problem, you lay the blame at someone else's doorstep.

The sponsors of the four bills mentioned in the Committee press release are taking a positive approach to the structural trade deficits. Senators Bentsen and Danforth correctly analyzed the long term nature of the problem, the importance of R&D to our competitive position and the relationship between trade deficits, inflation and JOBS.

Inevitably, the proposals will be "costed out" by Treasury and the Joint Committee staff. Hopefully, they will add a rational "feedback" for the proposals. Simply assuming that despite added tax incentives, R&D efforts will not be changed, will doom any intelligent tax program before it gets off the drawing boards. The critical issues involve which combination of writeoffs and credits will get the most bang for the buck.

Having served on this Committee's staff for over ten years, I have learned to be very suspicious of official Treasury revenue estimates. I am sure many Members witnessing the yo yo pattern of revenue estimates are also skeptical. More often than not, these official estimates appear to tailor assumptions to reach foreordained conclusions. I could cite many examples under both Democratic and Republican Administrations, but will not take your time to do so, unless requested.

As to the budget implications, we agree with Senator Byrd's statement "In light of the costs of energy imports, we cannot afford not to have a program to increase exports. And we should be especially interested in encouraging medium-size and small companies to export."

We completely agree -- even with the emphasis on medium-size and small companies. However, we cannot fail to mention that U. S. exports are and will remain a big business; the risks are great; coping with the maze of U. S. and foreign regulations; currency fluctuations and exchange risks is not a particular environment that "small business" thrives in. Nevertheless, we should do everything reasonable to encourage medium and smaller sized firms to become exporters. Many of the innovations that have greatly enriched our nation have come from the "Tom Edisons" in smaller firms. Innovation should be encouraged in every reasonable way.

At the same time we should avoid the trap of clobbering "big business" with punitive measures to theoretically recover sufficient revenue to subsidize "small business". Big business provides the majority of the jobs, the income, the taxes that make the economic machine work. In fact big business in many instances keeps small business alive through billions of dollars worth of subcontracts and supplier relationships.

We are not in a position to provide you with a cost benefit analysis of the proposals that are before you. We do promise to ask all of the tax and economic experts in our membership for their thoughts on what should go into a comprehensive export incentives program and provide this Committee with the benefit of their views.

The fundamental problem is that the Administration appears to believe there is no problem, or at best, they underestimate the magnitude of the trade problem. I am tempted to believe that some of the economic theorists in the Administration feel trade deficits are good -- that they keep the rest of the world afloat. They reason that if we ended the deficits the poor developing countries would "go under". I really believe it is this attitude which underlies the refusal to do anything positive to encourage exports and in fact to take actions, administrative and regulatory, to discourage exports. Our problem is not only foreign competitors and their barriers, but our own attitudes and actions. We constantly subvert a tough realistic trade program to tax theory or foreign policy considerations.

These theorists are wrong. We cannot resolve the world oil deficit problem by continuing to run U. S. deficits to finance some developing countries mounting debt to other developing countries. By doing that we erode the value of the dollar, lead to greater OPEC price rip-offs and further damage the developing countries and ourselves. Moreover, our deficits are not the surpluses of the poor developing countries; they are with the rich industrialized countries and with OPEC.

If the present trade deficits persist for another year or two we believe our nation's currency will be persona non grata; that the protectionism all the high theorists fear will indeed occur, and a massive economic earthquake will will ensue. Perhaps that sounds alarmist, but these are not ordinary times. The prestigious Bank for International Settlements (BIS), sometimes referred to as the "central bank's central banker" recently issued an annual report which stated:

> "A loss of confidence in the dollar due to a large current account deficit is likely to lead to a disorderly and excessive depreciation, fueling inflation in the United States and causing excessive appreciations elsewhere -- not to mention its impact on the prices of oil and other commodities."[1/]

On Saturday, June 9, the Congressional Budget Office warned Congress to expect a full-fledged recession this year and through most of 1980.

The warning signals are there but the Administration appears to ignore them. Never in my lifetime has the international economic (and political) system appeared so fragile. It's nice to have an Export Council of 40 distinguished Americans; I only wish we could have a positive, meaningful export program. It took almost a year to get a Council; how long do you think it will take 40 people to agree on a program, when they meet but several times a year, even though they be very capable and well intended.

1/Reported in Washington Post, June 11, 1979, p.D 10.

Mr. Chairman, there is an urgent need for a comprehensive export incentives package - NOW! The problem is too serious and too urgent to nickel and dime it to death. If the Congress wishes to make American corporations "export conscious" the program must be bold. This is not just my view: the Chairman of the President's Export Council, Reginald Jones, has spoken often and forcefully for a strong export program. The interest in this hearing among various elements in the export community attests to the importance of the issue. May I suggest, Mr. Chairman, that the Subcommittee request the official views of the Export Council on the proposals before you. Moreover, Bob Strauss, Frank Weil and John Moore all appear extremely concerned about the export problem. All are experienced businessmen and bankers who understand the nature of the export business. If they were allowed to express their own independent judgements, I believe they would support a positive incentives package including many of the provisions in the legislation already introduced. It would surprise me if, under those circumstances, these distinguished men would continue to talk the problems without supporting an action program to eliminate those problems.

Mr. Chairman, this concludes my statement. I have tried to be honest and straightforward in my support of what I consider to be an absolute imperative: a positive export trade program for this nation, the only industrialized nation without one. I will be happy to answer any questions.

[From the Journal of Commerce Staff, May 29, 1979]

Research, Development Climate Deteriorates in the United States

(By Sidney Fish)

The climate for research and development has deteriorated in the U.S. As a result, spending for R & D has been de-emphasized by some corporations, as they evaluate the different areas in which they place their investment dollars.

Figures compiled by the National Science Foundation show that research and development, as a fraction of the federal budget, has declined 34 percent during the period from 1968 to 1978. Investment by industry, as a percentage of net sales, has dropped 32 percent during the same period. The percentage of scientists and engineers engaged in research and development has declined 57 percent in the U.S.S.R. and in West Germany, and 62 percent in Japan.

LEADERSHIP ENDANGERED

Technological leadership of the U.S. in many industries is endangered by the de-emphasis of R & D in the U.S. In addition, it is estimated that one-third to one-half of the growth rate of the gross national product in the U.S. is based on innovation in products.

The National Science Foundation estimates that research and development, as a percentage of gross national product has dropped 20 percent in the U.S., while it has risen 15 percent in the U.S.S.R., 16 percent in West Germany and 20 percent in Japan.

STRONG PROGRAMS NEEDED

Strong R & D programs are needed in the U.S. to achieve a favorable balance of payments. The favorable trade balance of R & D-intensive industries was $29 billion in 1976, nearly five times as much as it had been in 1960. The industries that are not R & D intensive showed a $16.5 billion trade deficit in 1976, compared with only $179 million in 1960, according to an analysis by the Department of Defense.

The squeeze of R & D spending comes from several sources. R & D is extremely expensive. It represents a big gamble for a corporation. At the same time, capital investments have become much more expensive, partly as a result of mandatory spending for environmental controls. Evaluating the advantages of growth from within, through R & D, as contrasted with growth through mergers, some companies are electing to pursue the latter route, as one that affords quicker and more certain results.

Important disincentives to investments in R & D have also been provided by new laws and new legal theories of government agencies. The Kefauver Act of 1972, controlling the approval of new drugs, has led to a sharp drop in the number of new drugs that are entered in the U.S. market each year by corporations. Since the passage of this act, new drugs entering the marketplace have averaged only 15 a year, compared with 43 a year from 1948 to 1962. The Kefauver Act required a much more detailed presentation, in some cases involving hundreds of thousands of pages, to obtain approval for a drug from the Food and Drug Administration. A new Drug Reform Act has been proposed to streamline the approval process.

As a result of this law, much drug innovation has been transferred overseas. In 1963, 67 percent of all drug patents were originated by U.S. residents and only 33 percent by foreign corporations. By 1977, the proportion accounted for by U.S. citizens had dropped to 54 percent, while foreign applicants accounted for 46 percent.

Owing to the length of time needed to obtain approval of drugs, domestic companies find that often much of the 17-year period of protection afforded a recipient of a drug patent has expired before he can market the drug.

Another discouraging regulatory development has been the efforts of the Department of Justice and the Federal Trade Commission to "protect competitors from competition" through new antitrust theories. Companies that achieve a dominant position in the marketplace are often viewed by these agencies as monopolies, although their dominance may have resulted merely through heavy spending and risk-taking in research and development.

These antitrust agencies are often sympathetic to please from smaller or less well-established companies that new technological developments of the successful companies are threatening their survival.

Senator BYRD. The next witnesses will be a panel of three: Mr. Thomas J. McHugh, chairman, National Association of Manufacturers Corporate Income Tax and Capital Formation Subcommittee; and Mr. Richard Brust, chairman, NAM International Taxation Subcommittee on behalf of the National Association of Manufacturers.

Mr. EDWIN S. Cohen, chairman of the Taxation Committee of the Chamber of Commerce of the United States.

Mr. RICHARD C. Fenton, Council on Small Business Exports.

Welcome, gentlemen. I assume that you will divide up the time among yourselves.

Mr. MCHUGH AND MR. Brust have 10 minutes; Mr. Cohen has 10 minutes and Mr. Fenton has 10 minutes.

STATEMENTS OF CLIFF MASSA III, CHAIRMAN, NAM CORPORATE INCOME TAX AND CAPITAL FORMATION SUBCOMMITTEE, AND RICHARD BRUST, CHAIRMAN, NAM INTERNATIONAL TAXATION SUBCOMMITTEE ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. BRUST. My name is Richard Brust. I am vice president for taxes for 3M Co. and chairman of the International Taxation Subcommittee of the National Association of Manufacturers.

Due to a death in his family, Mr. McHugh could not be here. In his place, I am accompanied by Mr. Cliff Massa, NAM vice president and staff director for the Taxation Subcommittee.

We appreciate this opportunity to appear. Since manufacturers are all concerned about the quantity for American goods. Two-thirds of the dollar value of U.S. exports comprise manufactured goods. These exports provide one out of every nine manufacturing jobs for over 2 million workers. That is an active export market for American products and is important for a healthy economy.

In the interests of time, and based on the good presentations made, I think that we are aware of the problems. Without repeating some of the comments I would skip to a split in the program between Mr. Massa and myself and, Mr. Chairman, Mr. Massa will cover the capital recovery of the problem and I will cover the R. & D. problem.

Mr. MASSA. I should note, Mr. Chairman, that while we are addressing tax proposals this morning, another department of the NAM is very much involved with other areas, other types of legislation affecting exports.

Just for the record, we are in the area of an improved Export Administration Act, improving procedures to eliminate unnecessary procedures on U.S. export opportunities, including foreign policy and national security.

Export controls. We support the efforts to eliminate foreign-imposed barriers to U.S. exports and generally to restrain Government involvement in world markets, a matter that distorts trade flows.

While such policies are important, the general economic situation appears to us to be a major factor that determines the competitiveness of U.S. exports over the long term.

Much has already been made this morning of the problems that the United States faces with productivity. I will not go into detail

on the figures, just to note the sagging productivity gains for the United States, from a 2.9 percent average growth from 1959 to 1968 to averaging only 0.4 percent for the last 5 years and a rather disturbing report from the Department of Labor for the first quarter of this year which points to an annualized negative 4.6 percent productivity gain for this year, all of which causes us considerable concern.

We are looking at relatively low rates of productive investment in the United States compared to our foreign competitors. The stock of American physical capital—plant and equipment—must be increased if we are going to provide the efficient tools needed by American workers to improve productivity, thereby improving the competitiveness of U.S. goods in world markets by restraining price increases, if not helping to reduce them.

Three areas of concern that affect investment are excessive Federal regulation, inflationary budget policy, and counterproductive tax policy. We applaud the efforts of the administration and the Congress to work on two of these areas already, excessive regulation and deficit spending, but we think it is also appropriate to take a good, hard look at tax policies.

In our view, the depreciation reform proposals which have been proposed in the last couple of years, and others which we feel will be made this year, are the fundamental reforms needed to improve productivity, productive capacity, and the competitiveness of U.S. goods.

The existing system of useful life depreciation is, in our view, exceedingly counterproductive. It forces a much higher cost of capital on the economy and makes the investment in new plants and equipment much too expensive, particularly compared to our foreign competitors.

We applaud the efforts of Senator Bentsen and other members of this committee who, in the last 2 years, have focused the attention of the country on the need for depreciation changes, and while not saying any one particular approach is ideal, we do feel a major change in the depreciation system, moving away from useful life, is essential. The sooner we get about that business, the better.

We do not expect to be very active in this area during Congress, because we think the increased desire of American industry to invest in input will create a greater market for the investment and research and development to produce those new, innovative technologies. We feel these proposals which are before you go hand in hand. We urge the committee and the Congress attention to be focused particularly on depreciation policy whenever the next tax bill begins to move.

With that, Mr. Chairman, I would like to turn to Mr. Brust to comment on the research and development matters before you.

Mr. BRUST. Research and development is a topic near and dear to the heart of our company. Just in my tenure at the company I have seen our research and development expenditures go from $5 million to over $200 million a year. We have a deep concern for that type of expenditure.

One factor which certainly is related to the productivity slowdown, and therefore to the erosion of our international competitive-

ness, is an increased rate of growth on our spending on research and development.

The background has already been stated, but briefly, for the period 1968 to 1978 the climate for R. & D. in the United States has deteriorated. R. & D. expenditures by industry as a percent of sales has dropped 32 percent. R. & D. as a percent of GNP has dropped 20 percent, where the reverse is true in West Germany, Japan, the U.S.S.R.

The technological leadership is being threatened. The percentage of scientists and engineers in R. & D. declined 13 percent, where the reverse is true in the U.S.S.R. and West Germany, up 50 percent; Japan up 62 percent. One-third or one-half of our growth rate of GNP is based on innovation and new product.

Senator Danforth, in his bill, S. 700, has made the points that our declining trade position is due to a slowdown in the U.S. growth rate in productivity. There is a favorable correlation between the intensity of R. & D. on export performance. There is a similar correlation between R. & D. activity and productivity growth, and R. & D. as a percent of GNP has declined from 3 percent to about 2 percent currently from about 1964 and in constant dollars from 1967 to 1977 we have seen a 4-percent drop in R. & D. whereas in the period 1961 through 1967 the U.S. experienced a 6-percent annual increase.

The energy crisis has diverted R. & D. dollars and Federal regulations and environmental concerns and OSHA and consumer protection has likewise diverted R. & D. dollars.

This is particularly true in our company. A lot of the regulations have cut down the effectiveness of R. & D.

We are all familiar with perhaps the current R. & D. type tax treatment where corporations are allowed to deduct current expense, entire R. & D. or, at their election, to be amortized over 5 years. If these expenditures result in a property, useful life, those costs must be recovered over that life.

It is important that we note in R. & D. that we spent that money originally to come up with an idea, but that cost only represents 10 percent of the total cost to bring that product to market and it is in these additional costs that it is important. That has a tremendous tie-in with the capital recovery type thing that Mr. Massa referred to.

Likewise, sometimes these costs go on for 15 years before they are matched by revenue. One particular problem, a very troublesome problem in the R. & D. area, is the regulation 1.8618. Senator Bentsen asked a question that I would like to make reference to.

We consider this to be a tax disincentive, and it is just a basic problem that in 1977, the IRS firmed up the regulations which, in effect, serve to limit corporations in the foreign tax credit.

Senator BYRD. Thank you, Mr. Brust.

Anything additional will be published in the record.

Mr. Cohen?

[The prepared statement of Edwin S. Cohen follows:]

STATEMENT OF EDWIN S. COHEN, CHAIRMAN, TAXATION COMMITTEE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. COHEN. Thank you, Mr. Chairman. I am Edwin S. Cohen. I am a member of the board of directors of the Chamber of Commerce of the United States, and chairman of its taxation committee. I am a member of the law firm of Covington & Burling in Washington.

The chamber of commerce is delighted to have the opportunity to participate in these hearings today with respect to various proposals relating to exports and capital formation. We think they are of the utmost importance, and we are very pleased that the committee is inquiring into the subject

Some months ago, the chamber appointed an export policy task force, and that task force produced a statement of policies and programs for expanding U.S. exports which contains a number of recommendations for the business sector and the government sector, both with respect to taxes and other areas.

Mr. Chairman, if I may, along with my prepared statement, I would like to submit a copy of this statement of policies and programs for exports for the record.

Senator BYRD. Yes. That will be published in the record, Mr. Cohen.

Mr. COHEN. Thank you, Mr. Chairman.

Tax policy is obviously a significant and important phase in the matter of exports. We think that one of the strongest moves that can be made to support exports would be to support capital formation itself in its broadest context.

S. 231, which is before you, would seek to do so by increasing the presently allowed variance in the ADR depreciation system from 20 percent to 30 percent and would produce a simplified schedule for depreciation by small business.

The chamber has been concerned about the slowing of growth in productivity; about the fact that fixed investment in the United States as a percentage of gross domestic product is low compared to that in other countries; and with the problems of inflation that have increased the cost of replacing fixed assets.

We believe that this problem needs prompt, early attention.

It is our inclination that it would be better to proceed by adopting a simplified capital cost recovery system, and we have been working on this with other organizations, particularly in an effort to see if we can produce agreement in the various sectors of business, between small business and the larger businesses, and agree upon a suggestion that we can all support.

We believe the proposal is likely to appear shortly, and we believe that it is likely to be toward a simplified capital cost recovery program. But we think S. 231 would be a step in the right direction.

With respect to research and development expenditures, the chamber is convinced of the need to stimulate expenditures in that area.

Senator BYRD. Excuse me. Mr. Cohen, that is the 5-minute bell. There is a vote in the Senate. Senator Bentsen left early to vote and he will be back just momentarily, so the committee will stand

in recess just for a moment until Senator Bentsen is able to get back and Senator Packwood and I can vote.

[A brief recess was taken.]

Senator BENTSEN. The hearing will come to order.

Mr. Cohen, I believe you had 5 minutes remaining.

Mr. COHEN. I had covered the matter of depreciation and the capital cost recovery system which we think is important to institute. I had just started with respect to research and development expenditures.

The chamber believes that attention to research and development is a matter of prime importance and we are delighted that the committee is considering this very important issue.

We have some question as to whether the specific language of the two bills dealing with this is the appropriate way in which to proceed. It may be that this can be corrected by further definition.

Our problem is that S. 700 would allow a 10-percent investment credit with respect to expenditures falling under section 174, dealing with research and development expenditures. Under current law, it is not quite clear what is deductible under section 174 and what is deductible as an ordinary and necessary business expense under section 162, and often it does not matter.

But if you allowed a 10-percent investment credit solely for those expenditures under 174 and not for those under 162, it would be a matter of prime importance.

We cite as an illustration the problem of computer software costs in which the IRS ruled some 10 years ago that those amounts would be accorded the same accounting treatment as would be available under section 174 because computer software costs so closely resemble the expenditures for research and development under section 174. But the Service never said that these costs were covered by section 174.

I think that the bills, if you go forward with them, should make an effort to define more precisely the items that are covered. Otherwise, using the tax structure may not be the best system, because the Internal Revenue Service is not particularly well-equipped to determine what constitutes research and development expenditures, or what expenditures are of the kind that Congress intends to foster, and what are not.

We think it would result in substantial litigation and uncertainty.

But the chamber supports, with strength, the stimulation by Government in one form or another of research and development expenditures.

We have some minor comments with respect to S. 1003, with respect to specific provisions. For example, there is a provision to amend section 174 to deal with market surveys. We would think that it is important that these items should be currently deductible, but the bill refers only to their current deductibility with respect to surveys of foreign markets, and we think that it should currently be deductible, even in the case of research with respect to domestic markets, and we believe that they are. So if these bills go forward, we think that they should not contain any inference that similar deduction is not available for expenditures in connection with the domestic market.

While you were out, Senator, I said that the chamber had formed a task force, and had produced a statement of policies and programs for expanding U.S. exports.

I ask that a copy of the pamphlet or brochure that sets forth a number of these proposals from the chamber be submitted for the record.

Senator BENTSEN. That will be made a part of the record.

Thank you very much.

Senator BENTSEN. Please proceed, sir?

STATEMENT OF RICHARD C. FENTON, COMMITTEE FOR SMALL BUSINESS EXPORTS

Mr. FENTON. I am Richard C. Fenton. I have my own company of management consultants working primarily with smaller companies involved in exports and I am here representing an organization which has just been started called the Committee for Small Business Exports.

I have just come back from a trip to Europe and have not had time to examine carefully the four bills which are in front of you, nor have I been able to get expert advice, and I am not a tax expert.

I would like to look at S. 1003 and S. 700. Both could be of much interest, if I understand them properly.

I am gratified that you, Senator Bentsen and Senator Danforth are so interested. I could not be more pleased with the statement that the chairman, Senator Byrd, made at the time of his announcement of this meeting. It is very appropriate, and high time—I have believed for a long time, at least since 1963, that smaller and medium-sized companies must be provided with incentives to export and to engage in international business if the United States is ever to solve its balance-of-payments problems.

Smaller and medium-sized companies cannot, in the short term, make a major contribution. This must come from the large multinational corporations, which are the large exporters and the source of repatriated foreign income and have the largest amount of production abroad.

However, my personal experience is that smaller companies can become large corporations. A company exporting $1 million in 1979 can be exporting $50 million or $100 million in 1989. I have seen it happen.

However, the carrot of future large profits and cash flow must itself be sufficiently enticing to overcome the present high cost and initial problems.

Therefore, our first recommendation must be that smaller and medium-sized companies, both those now exporting and those which could export, be provided with substantial incentives, specifically designed to encourage them to export more.

The problem that I see with some of these bills is the reverse of Mr. Cohen's problem. I do not want to make the incentives equally applicable to the U.S. market. I want to make them, as you have done, specifically for export. That is the only way that chief executives of companies will be encouraged to turn their time and attention and money toward exports and away from exclusive preoccupation with the domestic U.S. market.

I have heard many proposals over the years for suitable incentives. I have not, so far, heard any that, in my opinion, would be as attractive as tax incentives, provided the latter are substantial enough.

Before 1963 and subpart F the United States had a tax incentive for exporters, since a U.S. corporation was permitted to defer export profit, if earned through a foreign corporation. Many of our principal foreign competitors still have situations like this.

After much debate within the administration and the Congress, this situation was partially restored through the DISC legislation. Because of the strict pricing rules and the "deemed distribution", even before the incremental rules were established in 1976, only about one-quarter of the tax on export profits was, in fact, effectively deferred through DISC.

This is a modest incentive indeed, and it has been made more modest by the 1976 changes. However, the DISC exists, and it has proved an effective incentive for many smaller and medium-sized companies.

I have had contact with several hundred such companies with DISCs and almost unanimously they believe strongly that their DISCs have stimulated and helped them to increase their exports. They firmly believe that the DISC law has been effective in its purposes and should be improved and made more effective. They are convinced that their DISC's have been cost-effective to the United States and that their DISC's have generated additional exports that would not have taken place without them, and that these additional exports have produced more tax revenue to the U.S. Treasury than the tax deferred in their DISC's, and this is a very important point.

Therefore, our second recommendation must be that unless and until some better incentive can be devised and put in place, the DISC should be retained and improved, regardless of the wishes of our foreign competitors. It is in the interest of foreign countries, as much as in our own interests, that the United States should solve its balance-of-payments problem.

The DISC, as it stands, is a modest incentive for smaller and medium-sized companies. The costs of entering export markets in a sophisticated way are high; the payoff could be a long time coming. An incentive must be correspondingly substantial to be effective.

At least for smaller and medium-sized companies we need DISC to be more like the original proponents had in mind. We recommend two changes to improve the incentive for smaller and medium-sized companies at least. First, the "deemed distribution" of 50 percent of DISC income should be eliminated to permit 100 percent instead of 50 percent tax deferral on at least the first million dollars of DISC income.

Actually, because of the pricing rules, a 100 percent deferral would not take place. It would be nearer 50 percent of total export profit after this change.

Second, the small DISC exemption to the incremental rule should be increased to $1 million also. I am not sure, in either case, that $1 milion is high enough, but it will help.

It may be objected that the cost of these changes to the U.S. Treasury is too high. We would urge that the additional exports

which would result from the changes would produce more tax than the additional tax deferred.

There are some practical problems with DISC that need to be addressed. First, the law and regulations have become very complicated. Large corporations have large financial and legal staffs and the financial ability to pay for outside advice. Smaller companies may have one experienced financial man on the payroll and probably no lawyer. They do not have the profit and cash flow to spend on much outside help.

If the chief executive himself cannot make time to understand the subject properly, probably nothing will be done.

The next recommendation is, therefore, that the regulations and documentation requirements be simplified and streamlined at least for smaller and medium-sized companies. There are some fairly simple ways to form and operate a DISC, but they are not known to most chief executives of smaller companies. No publicity appears to be given to them by the Government.

An incentive is not likely to be effective if it is not known about and understood by the companies for which it is intended. We recommend that the Congress somehow persuade the appropriate executive departments to give intensive and effective publicity to these more simple ways of forming and operating a DISC as well as to the simplifications which will, hopefully, now occur.

One of the major problems with DISC is that, at least since 1965, which was only 4 years after enactment, it has been the subject of intense controversy in Congress and the Executive. Many smaller and medium-sized companies have been unsure whether to form and use the DISC. They did not understand what their government's policy was, and still do not.

On the one hand, they are urged to export more and on the other, the only practical incentive available to them is threatened with extinction.

What can be done about this, we do not know, but it would certainly improve our national export policy if it could include an unequivocal statement that DISC is part of it.

There is some talk about designing new incentives to replace DISC. We would certainly be willing to participate in a consideration of alternatives, but our criterion for judging proposals would clearly be, whether they would be better incentives for small and medium-sized companies than what we have now, hopefully improved as recommended.

At least, we hope and urge that the experience and views of smaller and medium-sized companies will be sought and listened to in this process. Top executives of such companies are more likely to be able to give reliable advice as to whether any particular proposed incentive would be effective in its purpose than specialist financial or legal people, or bureaucrats. It cannot be too strongly emphasized that the primary purpose of an incentive is to persuade chief executives of target companies to pay more attention to exports and international marketing.

They will do this if they can see clearly and without the help of specialist tax advisers, accountants, lawyers, and economists that international business will be at least as profitable as domestic, U.S. business.

Senator BENTSEN. I must inform you that your time has expired.
Mr. FENTON. Thank you, Senator.
Or at least sufficiently profitable to justify their greater personal attention and time, and their decision to allocate more of their very limited financial and human resources to it.
Senator BENTSEN. Thank you very much, gentlemen.
Mr. Fenton, you were talking about incentives. The Library of Congress has prepared a study for Congress on export tax incentives of major industrial nations.
For example, Japan provides overseas market development allowances which permit firms to deduct a percentage of their export profits from taxable income.
French banks and exporting companies are allowed to create deductible reserves to cover the risk inherent in the extension of credit.
What I have tried to do, and what Senator Danforth has worked on doing, is to try to point out some of the things that have been done by other countries. We are only talking about a quid pro quo. We are talking again about the value added tax, what has happened in other countries, what it does to give them a competitive advantage over the United States.
Mr. Cohen, with your very vast experience at Treasury, let me ask you about Treasury regulations under section 861 and the allocation of R. & D.
There has been some concern expressed that those interpretations of R. & D. under section 861 could result in some domestic companies moving some of their laboratories overseas. Would you care to comment on that?
Mr. COHEN. Senator, this is terribly complicated, but a terribly important point. I think, to boil it down, the Treasury regulations that were under consideration had proposed to allocate research and development expenditures worldwide, according to sales of the consolidated enterprise.
When you consider the foreign tax credit that is available to American companies, the company would suffer a reduction in its foreign tax credit if the research and development expenditures incurred here in the United States were deemed to be incurred pro rata abroad, because the sales occur abroad as well as in the United States. The companies urged the Treasury not to so provide in the final regulations, but to say instead that these expenditures made in the United States, benefiting, to such a great extent, the American economy, should be allocated to U.S. income rather than foreign income.
The Treasury did not do that, in the final analysis, but put in what is essentially an arbitrary formula with a phase in and I think that this has solved most of the problem. But, because the regulations phase in some of the rules, some of the companies will begin to feel the pinch.
I do think that it needs review.
It does seem to me that it is the role of the Congress to tell the Treasury as a matter of policy that research and development expenses occurring in the United States should be fostered and that their current rules, may, in fact, lead to some of it being done overseas instead of here.

A definite advantage exists, it seems to me, to have R. & D. conducted in the United States, so that we have the first patents and we have the know-how. R. & D. should not be allocated, pro rata, around the world.

Senator BENTSEN. Thank you very much, Mr. Cohen. I am sure that the chairman has explained to you that the rest of them went to vote. I left a little early. We are, in effect, cycling Senators. I do not want that to be an inference that I am talking about cycling tenures of Senators.

Senator DANFORTH. Mr. Cohen, I would be interested in any thoughts you might have on how "research and development" should be defined for the purposes of S. 700 or S. 1065. I would be most appreciative if you could submit them for the record.

Mr. COHEN. I am not sure, Senator, that I am in a position to do it. I would be glad to assist in any way I can, but I am not a scientist and I have not worked in this area.

There are some definitions, I think, that have been used by the National Science Foundation, and others. My concern is whether anyone who can spell it out in sufficient detail, in a few words in the statute, and there will be problems if it is not spelled out with some precision. It is difficult to leave it up to an Internal Revenue agent on an audit of a return several years after the expenditures have been made.

I think you will have considerable difficulty in that regard.

I pointed out while you were out the problem with respect to computer software costs where there was quite a controversy as to whether they should be capitalized or should be written off as the computer programs were developed.

The IRS finally resolved it not by saying that these costs were covered by section 174 as a research and experimental expenditure, but by saying there was sufficient similarity to those expenditures that software costs warrant the same accounting treatment as that accorded section 174 expenditures.

If you had a credit that applied only to expenditures covered by 174, that controversy would break out again, and it would be a major one.

I do not have the familiarity with all the different types of research and development expenditures to submit a program now. I will be delighted to make an effort and to work with your staff, but I do think that something of a more definite nature would be needed if you were to go this route.

I have a further problem with the other bill in respect to contributions by corporations to institutions, because there you have to determine what is fundamental research. We have had no experience with that expression in the tax code, and the bill also requires that it be fundamental research in the physical sciencies. I am not quite sure that medicine, for example, is a physical science, but I would assume it would be. Things of that kind are involved that I think cannot be left just to regulations to be issued by the tax people.

Senator DANFORTH. That is why I asked you for your help.

Mr. COHEN. I would be delighted to try.

Senator BENTSEN. Thank you for your help, gentlemen.

Mr. COHEN. Senator, could I raise a question with you that I am not sure I understood in Mr. Sunley's testimony this morning?

It seems to be of major importance. Mr. Fenton has discussed the DISC and I agree that it is a matter of major concern with respect to exports, but I was not clear as to what Mr. Sunley said with respect to the Government's position regarding DISC in light of the new Multinational Treaty on Trade.

If DISC were to be outlawed, it would create havoc, it seems to me, and I was not sure what he said with respect to it. I thought he said at one point that he thought that DISC would violate the new rules of the MTN.

On the other hand, he said at one point that the practices that were in existence at the time that the new agreement would come into effect would be deemed to be sanctioned, and that conceivably would encompass the DISC.

But it seems to me that that is a major matter to which attention should be directed, to clarify the position on the DISC in relation to the Multinational Trade Treaty.

Senator BENTSEN. It is my understanding—I believe it was the intention of the Finance Committee in our consideration of MTN that we made no decison on DISC and that we did not prejudice it in what we did.

I think that was the clear position of the Finance Committee.

We can go back and look, but I think Mr. Sunley was responding to a question. I do not believe that was a part of his prepared testimony, as I recall.

Mr. COHEN. That is correct.

Senator BENTSEN. We can go back to the record, but my interpretation was that he was saying if DISC were a new proposal it would not be in the spirit of MTN. But I got the feeling he was talking about its being grandfathered in.

We will read his statement, but I am sure in responding off the cuff that way, he might want to polish up his statement himself.

Mr. COHEN. I have read the language and it says that the new treaty will not be deemed to have an effect on the decison as to whether the DISC violates the GATT or not, but it does not say so, one way or the other.

I do not know what the understandings are.

Senator BENTSEN. It is a point that we should further buttress and get a further clarification.

Mr. COHEN. It is a matter of major importance, because we brought forth the DISC earlier in this decade in order to solve some of these problems and it is such a matter of importance, I think, that there should be no misunderstanding about it.

Senator BENTSEN. Thank you, gentlemen. Thank you very much.

[The prepared statement of the preceding panel follows:]

STATEMENT OF RICHARD BRUST AND CLIFF MASSA III ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Richard Brust, Vice President—Taxes, 3M Company; Chairman, NAM International Taxation Subcommittee.

Cliff Massa III, Vice President, NAM Fiscal and Economic Policy Department.

The National Association of Manufacturers (NAM) represents over 12,000 member companies which employ a majority of the country's industrial labor force and which produce over 75 percent of the Nation's manufactured goods. Over 80 percent

of the NAM's members are generally classified as small businesses. The Association is also affiliated with an additional 158,000 businesses through the National Industrial Council.

Manufacturers are vitally concerned with the climate for exports of American goods. Approximately two-thirds of the dollar value of total U.S. exports is comprised of manufactured products. These exports provide about one out of every nine manufacturing jobs, or over 2 million workers. Thus, an active export market for American products is important for a healthy economy.

U.S. EXPORTS

Current situation

Unfortunately, one of the major challenges presently facing the American economy is our declining balance of trade position. This year, the United States is heading for its third consecutive trade deficit of well over $20 billion. This is a figure that would have been unimaginable just a few years ago. (See Appendix—Table 1) This deficit often is blamed on the increasing cost of imported oil. While this is partially correct, the decline in our manufactured goods trade balance was more significant than oil last year in accounting for the increased trade deficit.

The export of manufactured goods has been declining both in absolute terms and relative to major U.S. trading competitors. In the period 1975 to 1978, the U.S. trade account in manufactured goods dropped from roughly a $20 billion surplus to a deficit of over $5.8 billion, as our imports of such goods rose sharply. During the same period, the surpluses of Germany and Japan have jumped to over $51 billion and $72 billion, respectively. (See the graph in the Appendix.) In 1970, Germany moved ahead of the United States as the number one exporter of manufactured goods and has since widened its lead. In 1970, the U.S. share of total world exports was 18 percent, but that share was down to 13.7 percent in 1977. It can be shown that each percentage point drop represents a reduction of over $1 billion in trade, which translates into 40,000 jobs, $2 billion in GNP, and $400 million in Federal tax revenue.

Causes of the problem

NAM has supported efforts to expand exports through such measures as extension of an improved Export Administration Act. We have encouraged procedures to eliminate excessive or unnecessary restrictions on U.S. export opportunities. Foreign policy and national security export controls should be narrowed to realistic guidelines. In addition, we support efforts to eliminate foreign imposed barriers to U.S. exports and generally to restrain governments from involvement in world markets in a manner that distorts trade flows and leads to unfair trade practices.

While such policies are important, the general economic situation appears to be the factor which determines the competitiveness of exports over the longterm.

Productivity.—A primary obstacle to a favorable trade balance is the general productivity slowdown throughout the 1970's. American workers remain the most productive in the world, but our rate of productivity growth has been falling dramatically in recent years. As shown in Appendix—Table 2, the average productivity growth rate from 1974 through 1978 was only 0.84 percent compared to 2.9 percent for the period 1959–68. In this decade, productivity increases of over 2 percent occurred between 1959 and 1969. The Bureau of Labor statistics has recently reported that the growth rate of American productivity for the first quarter of 1979, projected at an annual rate, was an alarming −4.6 Percent!

On the other hand, nearly all of our major trading partners have displayed average yearly productivity growth rates in excess of ours. For instance, Japan and West German's average productivity growth rates from 1972 to 1977 were 3.5 percent according to the 1979 Joint Economic Report. Should the present trends continue, France and Germany will surpass us in absolute productivity by 1985, and Canada and Japan will follow soon after. Our sagging productivity growth has an adverse effect on the price competitiveness of American goods. This is an important factor in the erosion of our export strength.

Total productive investment.—Significant levels of investment in new plant and equipment are essential to maintain a healthy productivity growth rate. The stock of American physical capital, i.e., plant and equipment, must increase to provide the efficient tools needed by workers to improve productivity. Outdated or worn out assets must be replaced. New technologies must be introduced and total capacity expanded.

Excessive Federal regulation, inflationary spending and counterproductive tax policy have inhibited that needed investment. As a result, American industry has

been operating with increasingly aging capacity while our foreign competitors' higher levels of new investment are giving them a growing competitive advantage.

Data compiled by the OECD notes that over the period 1966 to 1976, U.S. fixed nonresidential investment was 13.5 percent of gross domestic product, while Japan's was 26.4 percent. In fact, the U.S. percentage was one of the lowest of the major industrialized countries. (See Appendix—Table 3.)

DEPRECIATION

In order to reverse these trends and to improve longterm export opportunities, major policy changes are needed. The Congress and the Administration have begun to restrain regulatory and spending excesses. It is time to make a major tax change as well.

Federal tax law discourages investment in several ways. The double taxation of dividends, the high corporate tax rate, and the outmoded depreciation system are all biased against savings and investment. But depreciation policy is an area of particular concern. Depreciation deductions account for about two-thirds of gross private savings. Any positive change in depreciation policy will significantly increase the pool of savings and encourage much needed investment in industrial plant and equipment.

Cost of capital

Under the present system using long "useful lives" for depreciation, financial capital is tied up for inordinate periods of time. This increases the cost of physical capital because, during such periods, interest is paid on any borrowed funds and/or income is foregone on new investments. As cash flows are slowed over the long recovery periods, debt financing must replace the unavailable internal funds.

There is a considerable body of economic research that testifies to the fact that the cost of capital or the related rate of return is a primary determinent of investment behavior. Obviously, reducing useful lives or eliminating the concept altogether would decrease the cost of capital and encourage sizable new investment in plant and equipment. Such investments can improve the efficiency of industrial operations and restrain price pressures.

Capital recovery

NAM supports efforts to speed up the recovery process. The advocacy of Senator Bentsen (D—TX) during the Senate's consideration of the 1978 tax bill and this year has helped to bring depreciation to the forefront in tax policy discussions. The legislation introduced by Senators Nelson (D—WI), Heinz (R—PA) and Chafee (R—RI) and the strong support for depreciation reform of Senators Packwood (R—OR) and Danforth (R—MO) give us real hope that the next tax reduction bill will include a major change.

NAM expects to be very active in this area during this Congress. A rapid system of capital recovery allowances can provide a very constructive boost to investment in new plant, equipment and jobs. We view this route to expanded and improved domestic industrial supply capacity as the key to the longterm improvement in U.S. exports.

RESEARCH AND DEVELOPMENT

Current situation

One factor which certainly is related to the productivity slowdown and, therefore, to the erosion of our international competitiveness is the decreased rate of growth in spending on research and development. As has been noted by Senator Danforth, R. & D. spending as a percentage of GNP has declined from 3 percent in 1964 to 2.2 percent in 1977. The National Science Board of the National Science Foundation has projected that this level will fall to 2 percent by 1985. In constant dollars, 1977 outlays actually were 4 percent below the 1967 level.

Industrial innovation is essential to productivity. High levels of basic and applied research are necessary to develop that innovation. While the United States still spends more on R. & D. than any other country (about $50 billion in 1979), a large proportion goes for defense spending. Increased Government regulation has diverted much R. & D. spending to compliance with Federal standards which may be desirable for social goals but which are not generally productive in an economic sense.

Our foreign trading partners devote a larger proportion of GNP to R. & D. and a larger percentage of this spending to non-defense research. It is the rate of domestic R. & D. spending growth which is at question. It much be increased.

Current R. & D. tax treatment

The basic tax rule under sec. 174 allows R. & D. expenditures to be deducted currently ("expensed") or, at the taxpayer's election, to be amortized ratably over at least five years after benefits are realized from the expenditures. If the expenditure results in property with a determinable useful life, the costs must be recovered over that life. The investment credit is not available for sec. 174 property.

One particular tax problem has been the sec. 1.861-8 Treasury regulations which were made effective in 1977. These rules divide income and expenses between domestic and foreign sources. The effect on domestic R. & D. has been chilling and may worsen. While the rules are very technical, the effect is to encourage shifting of domestic R. & D. to foreign countries. This raises not only U.S. job issues, but also problems as to whether foreign governments would interfere with transfer of new developments back to the United States to benefit related domestic firms. The experience with these regs is rather limited so far, but we believe that their influence is adverse. This is an area which should be examined as part of the process of considering the R. & D. problem.

Tax credit proposals

The NAM currently does not have a recommendation on the proposals for new tax credits for R. & D. and for corporate contributions to institutions for R. & D. activities. We applaud the efforts of Senators Danforth, Bentsen and Moynihan (D—NY) to highlight the problems in this area and to encourage public discussion of possible approaches to it.

In general, we view the overall economic situation and investment climate as the major determinant of R. & D. spending. An increased desire and ability by industry to invest in more advanced plant and equipment may well be the inducement needed to raise R. & D. levels to produce the innvoations and technologies which such investments can utilize. The basic overhaul of depreciation discussed earlier offers this encouragement.

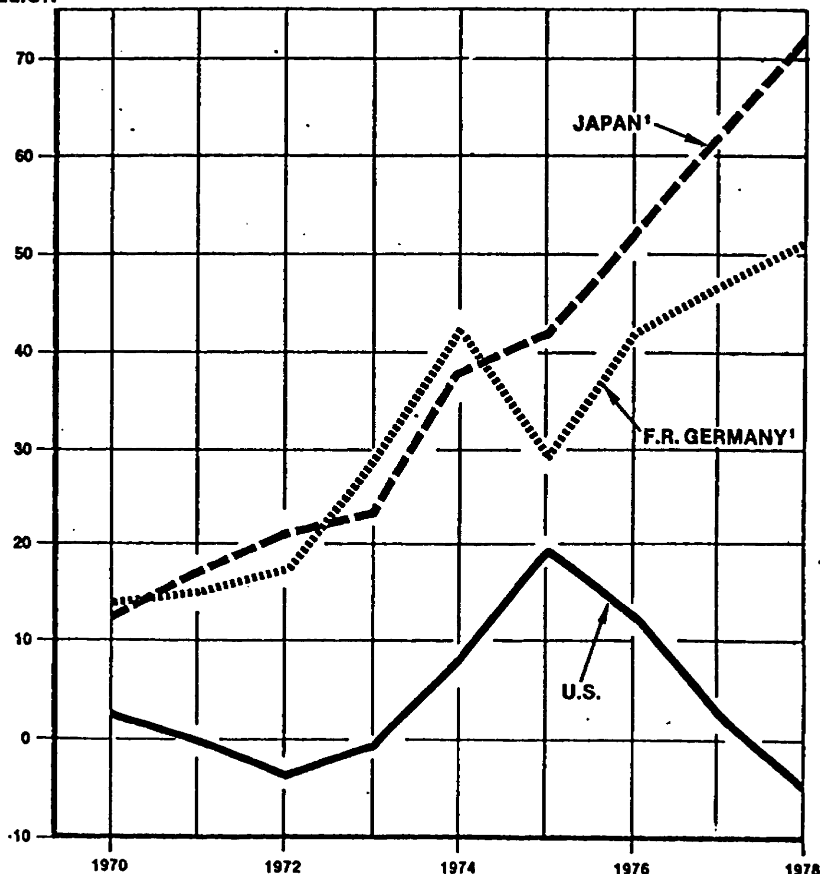
CONCLUSION

The NAM believes that it is imperative that our unfavorable balance of trade be turned around. The productivity slowdown over this decade has been a major cause of reduced competitiveness of U.S. goods on the world market. Productivity figures highlight the need to encourage more investment in industrial plant and equipment. Depreciation policy is a primary inhibitor of such investment, and the NAM strongly supports the elimination of the useful life concept in order to stimulate new investment in plant and equipment. Since reduced levels of spending for R. & D. may be due in large part to the sluggish rate of investment in new technologies, an improved climate for productive industrial investment should help to stimulate greater R. & D.

APPENDIX

BALANCE OF TRADE IN MANUFACTURES, U.S., F.R. GERMANY, AND JAPAN, 1970 - 1978

$BILLION



1. 1978 figure based on second quarter, annualized.

Source; Department of Commerce, International Economic Indicators

TABLE I.—U.S. TRADE BALANCE, 1970–77

[Dollars in billions]

Year	Imports	Exports	Balance
1979	40.0	42.7	2.7
1971	45.6	43.5	−2.0
1972	55.6	49.2	−6.4
1973	69.5	70.8	1.3
1974	100.3	97.9	−2.3
1975	96.1	107.1	11.0
1976	120.7	114.8	−5.9
1977	146.8	120.1	−26.7
1978	172.0	143.6	−28.5

Source: Commerce Department, *International Economic Indicators* and FT 990

TABLE II.—CHANGES IN U.S. PRODUCTIVITY

[Percent changes from preceding period, seasonally adjusted, for the nonfarm business sector]

Year	Percentage change	5-year period	5-year average
1959	3.3		
1960	1.0		
1961	2.7		
1962	4.3		
1963	3.4	1959-63	2.94
1964	3.6		
1965	3.4		
1966	2.6		
1967	1.7		
1968	3.2	1964-68	2.90
1969	−.3		
1970	.1		
1971	3.1		
1972	3.6		
1973	1.7	1969-73	1.64
1974	−3.1		
1975	1.9		
1976	3.5		
1977	1.3		
1978	.6	1974-78	0.84

Source: *Economic Report of the President, 1979* Department of Labor, Bureau of Labor Statistics

TABLE III.—*Real nonresidential fixed investment as a percent of real gross domestic product, 1966-76*

Country:	
Japan	26.4
West Germany	17.4
Canada	17.2
France (1970 to 1975)	16.7
United Kingdom	14.9
United States	13.5

Source: Economic Report of the President, 1979. Organization for Economic Cooperation and Development.

STATEMENT BY EDWIN S. COHEN FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES

My name is Edwin Cohen. I presently serve as a member of the Board of Directors and Chairman of the Taxation Committee of the Chamber of Commerce of the United States, on whose behalf I am appearing today. I am a member of the law firm of Covington and Burling, of Washington, D.C.

The Chamber of Commerce of the United States is the world's largest business federation, comprised of more than 81,000 business firms, 2,600 chambers of commerce in the United States and abroad, and 1,275 trade and professional associations. Small business is heavily represented in our membership. In fact, approximately 80 percent of our business members have fewer than 100 employees.

On behalf of the National Chamber's 85,000 business and trade association members, I appreciate this opportunity to present our views on the legislation pending before this committee, S. 231, S. 700, S. 1003, and S. 1065.

SUMMARY

Tax policy can play a significant role in export expansion, but must be viewed as one part of a comprehensive approach to the problem. The National Chamber has long advocated tax changes to foster capital formation, in the belief that an improved investment climate in this country would increase productivity, create jobs, reduce inflation, and improve our ability to compete for international markets. To

encourage the modernization and expansion of productive facilities in order to make American industry fully competitive, the present depreciation provisions should be replaced by a more efficient and simplified capital cost recovery system. In addition, the present investment tax credit should be increased, the corporate tax rate and the tax on capital gains should be reduced further, and the double taxation of corporate income should be eliminated. Adoption of the Chamber's capital formation program should significantly improve the competitiveness of American industry.

Evidence exists that the competitive position of United States industry in international trade has been declining. Contributing to this unfortunate trend has been the absence of a clearly enunciated national emphasis on export expansion, the lack of a carefully designed and consistent set of government policies and programs to encourage exports, and the insufficient awareness on the part of American firms and individuals as to the economic benefits to be derived from exporting.

To promote the expansion of U.S. exports, the United States must develop a long-range, comprehensive program which includes:

Increased export initiatives from the private sector;

The removal of a number of government disincentives to exporting;

The removal of foreign tariff and nontariff barriers; and

The adoption of consistent government programs to encourage exports.

CAPITAL COST RECOVERY

The Chamber believes that the adoption of tax policies designed to promote capital formation in the American economy would make a major contribution to an improvement in exporting. The report on U.S. Export Policies of the Senate Banking Committee's Subcommittee on International Finance recognizes the link between productivity growth and exports:

Over the long term, the most significant way to promote exports is to improve U.S. industrial competitiveness by encouraging innovation and productivity growth. The important circularity of causation between trade and domestic industrial growth should be more widely recognized, and U.S. industrial and export policies should be correspondingly integrated.

American firms face a distinct disadvantage with regard to replacing obsolete machinery and equipment, compared to many of their foreign competitors. To encourage the modernization and expansion of productive facilities that will enable American industry to compete more effectively in world markets, the present depreciation provisions should be replaced by a more efficient and simplified capital cost recovery system.

S. 231, introduced by Senator Bentsen, would provide more rapid depreciation to small and large businesses. The bill would increase the variance permitted under the Asset Depreciation Range (ADR) system from 20 to 30 percent. This would permit taxpayers who elect the ADR system to use a depreciation life for their capital assets within a range 30 percent below or above the predetermined life of the asset guideline class. In addition, salvage value would be disregarded for purposes of ADR computations. By reducing the time period in which the cost of a capital asset can be recovered, the bill would encourage business investment in additional plant and equipment. For small businesses, S. 231 contains a simplified depreciation table. Any business with a tax basis in assets (other than real estate) of $250,000 or less would be eligible to depreciate its assets on a straight-line method over useful lives shorter than those permitted under current law. This feature of the bill is intended to provide smaller firms with depreciation equivalent to that available to firms electing the ADR system.

S. 231 represents a significant attempt to accomplish a greatly needed improvement in the present depreciation provisions. Providing liberalized depreciation would increase capital investment and improve productivity. Moreover, moving toward the adoption of a capital cost recovery system would redress the significant understatement in present depreciation allowances relative to the cost of replacing capital assets.

The growth of productivity has declined significantly in recent years. According to the President's Council of Economic Advisers, between 1948 and 1965 productivity growth in the private nonfarm sector averaged 2.6 percent per year. This rate declined from 1965–73 to 2 percent, and since 1973 has averaged less than one percent per year. A major factor influencing this slowdown has been inadequate private investment.

Investment as a percent of gross domestic product (GDP) is lower in the United States than in other industrialized countries. In Japan, for example, investment is 26.4 percent of GDP, while the U.S. percentage is a low 13.5. This is illustrated in the following table:

Fixed investment as a percent of gross domestic product, 1966-76

Country	Percent
Japan	26.4
West Germany	17.4
Canada	17.2
France	16.7
United Kingdom	14.9
United States	13.5

Source: 1979 Economic Report of the President, p. 126.

Changes in current depreciation provisions to permit more rapid recovery of capital costs would be a major step toward correcting the declining rate of productivity growth and the low rate of investment.

Inflation causes replacement costs to far exceed depreciation allowances, with the result that corporate profits are significantly overstated. According to Department of Commerce estimates, depreciation allowances for 1977 were almost $15 billion short of replacement costs. Private economists place this figure much higher. Dr. Martin Feldstein, President of the National Bureau of Economic Research, Inc., has estimated that the cumulative effect of inflation reduced the depreciation allowed on existing plant and equipment by over $39 billion in 1977.

The Joint Economic Committee, under the able chairmanship of Senator Bentsen, recognized in their 1979 Report that certain corporate tax provisions designed in a noninflationary economy deter investment in times of inflation: Depreciation allowances based on historical cost do not allow sufficient deductions to recover replacement costs. The Committee recommended that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant of investment.

Small business partricularly would benefit from a change in current depreciation laws. Most small firms do not elect to write off their assets under the current ADR system, which they find too complex to use. The Treasury Department estimates that while nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36 percent with assets of $500,000 or less did so. Senator Gaylord Nelson (D-Wis.), long an advocate of tax relief for small business, has urged that: From the perspective of the small businessman who must comply with the law, wrestle with the regulations and fill out the forms, and then justify everything to the audit[or] afterward, depreciation reform is really an urgent necessity.

The depreciation table contained in S. 231 would provide small firms with a simpler system than is presently available. However, its usefulness would be as an interim measure in the movement toward a simplified capital cost recovery system that would apply to all business taxpayers.

While the Chamber supports the basic thrust of S. 231, we believe that even further changes in methods of depreciation and in the investment credit are desirable in order to stimulate capital formation, increase productivity and simplify the operation of the system, especially for small business. For some time, the Chamber has been working with other business groups on suggestions for an improved capital cost recovery system that would go beyond S. 231 and we hope that those suggestions will shortly be available. Adoption of a new simplified cost recovery system would be of major importance not only to the domestic economy but also in increasing the ability of American industry to compete in world markets.

RESEARCH AND DEVELOPMENT

The Chamber believes that enlargement of research and development activity in the United States is a matter of prime national importance, and that government should take steps to encourage an increase in expenditures by businesses to this end. These hearings serve to focus attention on this need.

The Chamber does have reservations at present, however, as to whether S. 700, allowing a 10 percent credit for expenditures qualifying under Section 174 of the Internal Revenue Code, would be desirable legislation, at least in its present form. We question whether a tax credit fashioned in this manner is the means of achieving the goal. This is particularly so since the credit would apply to amounts described by the broad term "research and experimental expenditures" in Section 174 without further definition.

Section 174 was enacted a quarter century ago to settle a significant controversy that had arisen as to whether such expenditures were required to be capitalized rather than deducted currently, and, if capitalized, as to the period over which to amortize them. Section 174 gave taxpayers the election to deduct such expenditures

when paid or incurred or to amortize them over such period, not less than 60 months, that the taxpayer selected. It is likely that most taxpayers have elected to deduct expenditures of this type when paid or incurred, in which event it is imaterial whether the expenditures are properly classified under Section 174 as "research or experimental" or as ordinary and necessary business expenses under Section 162. But if a 10 percent credit were to be allowed for expenditures covered by Section 174 and not for those covered by Section 162 or other provisions, the proper classification would be a matter of considerable importance.

A tax credit is doubtless most efficient as an incentive to conduct if the taxpayer knows in advance of making the expenditure whether the credit is available. The Chamber is concerned that without detailed definition there may be extensive controversy as to the scope of the credit, impairing its effectiveness as an incentive and imposing on the IRS the need for difficult policy decisions for which it is not best equipped. A broad interpretation would extend the coverage of the credit to expenditures for which the Congress might not intend the credit to be available, and might substantially increase the revenue cost of the measure; but a narrow interpretation would unduly limit its availability and cause substantial controversy and litigation.

As an illustration of the type of problem that might be encountered, it should be noted that the Service in 1969 disposed of a controversy that had arisen as to whether computer software costs constituted research and experimental expenditures deductible under Section 174. In Rev. Proc. 69-21, 1969-2 Cum. Bull. 303, the Service finally ruled that "the costs of developing software * * * in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of Section 174 of the Internal Revenue Code of 1954 as to warrant accounting treatment similar to that accorded such costs under that section." Thus, curent deduction of such costs is permitted, but without a clear decision as to whether they are covered by Section 174 or by some other deduction provision of the Code. A decision on this issue would be critical if an investment credit were to be allowed for those expenditures qualifying under Section 174.

There are certain other problems involved in the allowance of an investment credit for R. & D. expenditures, such as the extent to which it should be allowable to nonprofit organizations or institutions that conduct such activities. But we suggest that the primary issue to be faced is whether a statutory test for determining qualification for the credit can be devised that will provide sufficient certainty, eliminate extensive controversy, and reach the types of research and experimentation in the private sector that the nation should be attempting to foster through tax incentives.

S. 1065 provides an incremental tax credit of 25 percent for corporate contributions to tax-exempt educational organizations for fundamental research in the physical sciences if the results are freely available to the general public. The bill raises the question of determining the meaning of the expression "fundamental research" as distinguished from other research such as might qualify now under Section 174, as well as the matter of defining the "physical sciences." Without more, it would place a heavy burden of interpretation upon the IRS and the courts, and their decisions could have major effects upon the allocation of resources in educational organizations. We would suggest that further effort would be needed to clarify the scope of the bill before its effects could be fully appraised.

S. 1065 adopts an incremental approach, granting a 25 percent credit for the excess of the specified contributions over the average of such contributions made in the preceding four years (with reductions for decreases in contributions for other purposes). Incremental allowances of this type tend to be complex, since they depend upon comparison of figures over a span of years. They raise an issue of fairness, since they reward those taxpayers that have newly begun or increased their contributions as against those that have previously made substantial contributions.

The Chamber steadfastly supports efforts to increase research and development activity in the United States, but questions whether these two bills, at least in their present form, can provide a satisfactory solution.

S. 1003

S. 1003 has three separate provisions relating to export transactions. The first of these provides for a special addition to bad debt reserves for "export receivables," described as accounts receivable from the sale of eport property or services for use outside the United States. It is our impression that a large proportion of the property exported from the United States is sold on letters of credit, and therefore does not produce receivables. We have not thus far been able to determine the

extent of the cases in which American firms have receivables arising out of sales of export property or services for use outside the United States, or the extent to which American firms might encounter bad debts not otherwise covered adequately by their customary bad debt reserves. We would suggest that some clarification of this provision would be needed before an estimate of its effectiveness could be made.

The second provision would clarify Code Section 174, dealing with research and experimental expenditures, to ensure that deduction is permitted for the survey or analysis of foreign markets or products, for the marketing abroad of goods produced in the United States, and for expenses of applying for or maintaining foreign patents and trademarks. The Chamber believes that these items in general should be clearly deductible, whether under Section 174 or other sections of the Code, regardless of whether they are made with respect to foreign markets or domestic markets. We would caution that no action should be taken by the Congress with respect to foreign markets that might create an inference that similar expenditures in the domestic markets would not be deductible currently.

The third provision of S. 1003 permits a current deduction for losses due to foreign currency flucuations with respect to export receivables payable in foreign currency. The Chamber believes that this is a matter which requires attention by the Congress, but we would call to the attention of the Committee that there are other major income tax problems stemming from foreign exchange fluctuations that also require attention, and that the applicable rules need clarification.

In conclusion, the Chamber is grateful that the Committee is considering these basic problems regarding the need for increased research and development activities, the importance of increased productivity and capital formation in the United States, and the need to focus on export activities of American business.

THE NEED FOR A COMPREHENSIVE EXPORT PROGRAM

A Presidential statement last September elevated export expansion to the level of national priorty. However, further steps need to be taken to promote U.S. exports.

For the second year in a row, the United States in 1978 ran a trade deficit in excess of $30 billion dollars. This represented an acceleration of the trend over the last ten years of increasingly unfavorable international trade balances. A clear pattern for 1979 has yet to emerge. While in March the U.S. trade deficit dropped to $821 million, the lowest monthly level in two years, it rose to $2.1 billion in April, 1979. Regardless of the exact magnitude of the deficit, it is likely to be high enough to threaten the value of the dollar, fuel inflation, and further erode U.S. influence in international economic and political spheres.

The chamber urges the development of a consistent national export policy, and has prepared a comprehensive set of recommendations for expanding U.S.exports. A copy of this report, entitled "Policies and Programs for Expanding U.S. Exports," has been submitted for the record of the hearings. The report sets forth a long range program which seeks:

Increased export initiatives from the private sector;
Removal of a number of government disincentives to exporting;
Removal of foreign tariff and nontariff barriers; and
Adoption of consistent government programs to encourage exports.

Conclusion

We commend the members of this Subcommittee for their efforts to examine the effect of the tax system on exports. Tax policy is an important component in the analysis of the United States trade position. Adoption of tax changes designed to foster capitol formation should significantly improve the competitiveness of American industry. However, as the National Chamber's export policy recommendations indicate, tax considerations are only a part of a comprehensive approach to this serious problem.

POLICIES AND PROGRAMS FOR EXPANDING U.S. EXPORTS—RECOMMENDATIONS OF THE CHAMBER OF COMMERCE OF THE UNITED STATES FEBRUARY 1979

PREFACE

On September 26, 1978, President Carter announced his decision to elevate exports to a level of national priority and outlined measures his Administration would take to encourage and facilitate U.S. exports. Immediately prior to his public statement, at a special meeting in the White House, I expressed support for this first and important step. On the following day in a letter to the President, I pledged on behalf of the more than 80,000 members of the Chamber of Commerce of the United States our best efforts to work with the Administration and the Congress to

help implement his initative. In addition, I committed the Chamber federation to identify and develop further steps that could be taken—both by the private sector and the government—to help make the United States the world's premier exporting nation.

This report, which calls for a comprehensive plan of action by both the private and public sectors of the United States, is the result of the Chamber's commitment. The report takes the President's program as a starting point and builds upon it by recommending short and long-term policies and programs that are necessary to expand U.S. exports to a lever which will contribute significantly to redressing America's trade imbalance. It focuses on private enterprise initiatives, export-discouraging policies, regulations, and practices that must be revised, and programs that the government can provide to assist U.S. business and agriculture to realize their vast export potential. The recommendation contained in this report are the result of a careful blending of concepts and practical ideas developed by a broad spectrum of concerned Americans in business, academia, and all branches of government. They are not presented in any order of priority. Rather, they are set out as a comprehensive list of all of the areas that should be considered within a total priority of export expansion.

The prime responsibility for the preparation of this product lies with the dedicated, hardworking people who serve on the Chamber's Export Policy Task Force and whose names are listed in the beginning of this report. The Task Force's chairman for this project was John L. Caldwell, the Chamber's International Vice President. Howard L. Weisberg, the Chamber's Director for International Trade Policy, is the Task Force's executive secretary and, in this capacity, contributed significantly to the development and preparation of the report.

In addition, the men and women who serve on the Chamber's International Trade Subcommittee, chaired by Ralph A. Weller (Chairman of the Board, Otis Elevator Company), its International Policy Committee, chaired by Donald M. Kendall (Chairman, PepsiCo, Inc.), and the Chamber's International Division staff must be recognized for the many valuable contributions they made to the development of this document. Finally, the many U.S. businessmen overseas who provide leadership for the network of American Chambers of Commerce in forty countries contributed useful recommendations that are incorporated in this report.

The efforts of all of these people will be sustained by the intention of the United States Chamber of Commerce to pursue vigorously the policies and programs contained in this report.

RICHARD L. LESHER, *President.*

EXECUTIVE SUMMARY

The need for U.S. export expansion

The U.S. share of world exports has been declining since the mid-1960's and the U.S. merchandise trade deficit for both 1977 and 1978 was in excess of $30 billion. *The scope and magnitude of these deficits if not reversed, will continue to:

Weaken the value of the dollar, raising the cost of imported oil and other vital goods, raw materials, and services, and further fueling domestic inflation;

Encourage demands for protectionism, a path that could quickly make the U.S. economy still less competitive internationally, resulting in lost business and jobs; and

Erode U.S. influence in the international economic and political spheres.

America's comparatively weakened international trade position is caused by numerous factors, including much stronger competition from other industrialized and rapidly industrializing nations. However, a more significant cause for concern is the disappointing growth of U.S. exports in sharp contrast to the export success of other trading countries.

Exports account for 14 percent and 22 percent of the Gross National Products (GNP) of Japan and Germany, respectively, and some of our European trading partners export as much as 40 percent of their GNP. The United States barely exports seven percent of its GNP, and fewer than 200 companies account for more than 80 percent of U.S. manufactured exports.

The absence of a clearly enunciated national export goal; the lack of a cohesive, carefully orchestrated and internally consistent set of government policies and programs; and the relatively poor awarencess of American firms and people about the economic benefits they can derive from exporting all have combined to cause the decline in U.S. export performance *vis-a-vis* other nations.

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*The deficit figure is for manufactures and commodities. It should be noted that the U.S. trade balance in services has been positive for a decade, with a a growing surplus that reached $22 billion in 1978.

An export goal

President Carter's announcement on September 26, 1978, placing a higher priority on exports by his Administration, was a step in the right direction. But enunciating a policy and certain measures for export expansion is not enough. The United States must set an export expansion target and put into place the comprehensive policies and programs that are necessary to achieve its goals.

World exports of goods and services to 1982 are projected to rise at an annual average rate of 13 percent, compared to an anticipated increase for the United States of not more than nine percent. A realistic and attainable goal for the United States should be at least to close the gap between expected U.S. and world export growth rates. The combined efforts of the private and public sectors—based on the following recommendations—should enable the United States to achieve, if not surpass, the target of raising U.S. exports by an annual average of four percent.

Private sector initiatives

While government can do much more to foster and facilitate export expansion, the ultimate responsibility for transforming export potential into actuality rests with private enterprise.

Recommendations

(1) Business and agribusiness must take the lead in fostering an export consciousness in the United States and must increase the U.S. presence in foreign markets. These twin goals can be accomplished, in part, by greater educational and communications efforts; research and development for products and services tailored to meet foreign requirements; innovative joint venture arrangements; and more aggressive marketing, distribution, and servicing efforts.

(2) Greater use should be made of joint business councils as vehicles to further U.S. economic policies and programs abroad and to develop business opportunities in key countries.

(3) Trade associations and chambers of commerce should serve as catalysts to generate industry and region-specific exports, in closer collaboration with federal, state, and local government agencies.

(4) American chambers of commerce abroad should expand their efforts to promote U.S. exports in closer collaboration with U.S. based firms and business organizations.

(5) The United States Chamber of Commerce must expand its efforts, particularly in the legislative, program, educational, and communications areas, to encourage and facilitate export expansion.

U.S. Government disincentives must be removed

Export expansion is significantly constrained by complex, burdensome, and often internally inconsistent policies, regulations, and programs originally designed and intended to accomplish purposes unrelated to exports. Greater governmental sensitivity is needed to minimize the adverse impact of actions that may unnecessarily constrain export expansion.

Recommendations

(1) The international trade and investment roles of the federal government should be strengthened, streamlined, and made more effective by designating a cabinet-level official with the responsibility to prioritize and coordinate the international economic activities of government agencies and departments; by upgrading these roles in all relevant agencies; and by expanding the Commerce Department's responsibilities for promoting U.S. trade, investment, and service industry interests.

(2) Governmental regulations that have adverse effects on exports should be reevaluated and revised. Export impact statements should be an integral component of all regulatory measures. Regulatory restrictions on nonstrategic exports should be limited and the uncertainty surrounding numerous regulations should be removed. The Export Administration Act should be amended to ensure that the *bona fide* foreign trade interests of the Uited States are not impaired unnecessarily.

(3) Export licensing statutes, regulations, and procedures should be simplified, provide for speedier action, and be made to conform with multilateral arrangements supported by the United States.

(4) Discriminatory tariff and export credit policies applied against certain nonmarket economies should be removed.

(5) The inconsistency in antiboycott policies, laws, and regulations should be removed. Certain provisions of existing legislation should be monitored to ensure that their potentially harmful effects do not exceed the congressional intent to protect U.S. persons from discriminatory boycotts.

(6) Corrupt business practices must not be condoned in any form. While there is insufficient experience with the provisions of the Foreign Corrupt Practices Act, the unintentional adverse effects of the act must be closely and carefully monitored. Concurrently, multilateral agreements are needed to establish uniform standards of ethical and equitable business conduct.

(7) The extraterritorial application of U.S. antitrust laws should be harmonized with similar laws of our major trading partners.

(8) The Webb-Pomerene Act should be rewritten so as to remove statutory vagueness and broaden its applicability to include service industries. Greater efforts should be made to encourage small and medium-size firms to form Webb-Pomerene export associations.

Removing foreign barriers to exporting

The export generating effects of the "Tokyo Round" of the Multilateral Trade Negotiations (MTN) will be determined by the legislative implementation and enforcement of the agreements reached. Even when fully implemented, the MTN agreements will not have removed a variety of trade restraints.

Recommendations

(1) Continued efforts must be made to reduce tariff barriers, especially those that are maintained by more advanced developing countries.

(2) Nontariff barriers that were not dealt with in the MTN (e.g., border taxes) should be subject to ongoing bilateral and multilateral negotiating efforts aimed at their reduction or elimination.

Government programs to encourage exports

Government assistance can be particularly valuable for small and medium-sized firms which lack the resources and experience of larger companies to develop export markets. The export potential of all firms, in terms of both entry and expansion, can be tapped by providing them with specific tools of trade and a better trading environment.

Recommendations

(1) A U.S. policy of tax "neutrality" should be applied to place the U.S. exporter in the same tax competitive position as his major trading partners. The DISC tax deferral system should be retained and clarified. The value added tax system used in the European Community and sanctioned by GATT should be studied for possible adaptation as a substitute U.S. tax. The current system of deferring tax payments on overseas profits until they are distributed to shareholders should be maintained. Foreign tax credits should be maintained to avoid double taxation. Bilateral tax treaties to eliminate double income and social security taxation should continue to be negotiated. U.S. tax laws on foreign earned income should encourage, rather then discourage, U.S. nationals to work abroad. Multilateral negotiations should be undertaken to harmonize all export-related tax laws.

(2) U.S. export credit financing and insurance facilities must be improved and made more competitive with the terms and conditions offered by our major trade competitors.

(3) To the extent that the Export-Import Bank cannot be made more competitive through domestic legislation, bilateral and multilateral agreements should be negotiated to bring U.S. and foreign financing and insurance terms and rates within a tighter circle of comparability and to end predatory financing.

(4) Government programs to provide firms with technical and marketing assistance should be improved, and made more effective, particularly to aid new-to-export small and medium-size firms. Concurrently, the export promotion efforts of commercial offices abroad and the Commerce Department's domestic field offices should be more closely linked and made more effective.

(5) The United States should expand its network of bilateral treaties to protect and assist U.S. foreign investment and to foster commercial relations with nonmarket economies, but such treaties should not include cargo preference provisions.

(6) U.S. policies and legislation should encourage, rather than discourage, research and development to reverse the decline of U.S. innovation relative to our major competitors.

The United States has a vast export potential waiting to be tapped. By adopting the policies and programs recommended in this report, government and business can take that potential and turn the U.S. trade imbalance around.

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THE NEED FOR EXPORT EXPANSION IN THE UNITED STATES

Since the mid-1960's, the U.S. share of world exports has been declining fairly steadily. For both 1977 and 1978, the U.S. merchandise trade deficit was in excess of $30 billion.* The scope and magnitude of these deficits and the resulting cumulative adverse effects on key indicators of U.S. economic strength are now major concerns of public and private sector policymakers. While over much of the postwar period it was generally felt that international trade flows occupied but a minor role in U.S. economic activity, it has become clear in recent years that sizeable trade deficits pose serious constraints on the ability of the United States to develop further its socioeconomic well-being. National and international economic policies and developments have never before been so closely and significantly interrelated.

Three problems are particularly significant. First, the current trade imbalance fuels domestic inflation. Inadequate export performance has contributed to the sharp decline in the value of the dollar, causing imports to become more costly to consumers of final goods and services and to producers who require foreign raw materials and semifinished products in order to meet domestic demand. Foreign concern over the perceived inability of the United States to appreciably reduce its trade deficit in the foreseeable future has added further downward pressure on the value of the dollar in international currency markets, thus exacerbating inflationary conditions in this country. Second, lagging export performance has encouraged demands in the United States for protectionist measures in order to achieve trade equilibrium. However, sheltering uncompetitive domestic producers will only contribute to further deterioration of the international competitiveness of the U.S. economy, resulting in lost business and jobs. Third, a growing number of people both at home and abroad view the size and persistence of the U.S. trade imbalance as indicative of a decline in the overall strength of the United States. Thus, the trade deficit casts a shadow on this country's ability to continue in its role as the political, military, and economic leader of the Western world.

The declining U.S. trade position is attributable to a number of factors, including the increased ability of West European and Japanese producers to compete, in most areas, on relatively equal terms with their American counterparts, massive U.S. oil imports, more rapid economic recovery in the United States from the recent worldwide recession, and relatively abundant grain harvest abroad. However, we are concerned here with an additional cause of the trade deficit, namely the disappointing growth of U.S. exports in sharp contrast to the export success enjoyed by other industrialized and a growing number of developing countries. With exports contributing over $200 billion to the U.S. GNP and one out of every eight jobs in the manufacturing sector of the economy (10 million jobs overall), the view prevalent in some public and private circles that the size of the domestic market is adequate to meet the needs of an expanding economy has become increasingly outmoded. it is time to make export expansion a high priority in this country. General export consciousness must be aroused, and the public and private sectors made aware of the significant roles they can and must play to accomplish this objective.

Export expansion—A national priority

The decline in U.S. export performance *vis-a-vis* other industrialized countries is the result of complex and interrelated domestic and international developments that have been occurring over much of the postwar period but particularly since the mid-1960s. While a discussion of these developments is beyond the scope of this report, it is important to note that the growth of postwar world economic interdependence has meant that the industrialized countries are now more similar in terms of the broad structural characteristics of their economies. Productivity levels, real wage levels, and the costs of borrowing investment funds have been narrowing in the industrialized areas of the world. As a result, trade flows among the industrialized countries are increasingly sensitive to small adjustments in domestic output and prices, temporary technological advantages, skill differences, and other factors that can be and usually are affected by selective government policies.

In this regard, foreign businesses have a substantial competitive advantage over their U.S. counterparts because of the greater emphasis they and their governments place on the need to export in order to attain various economic and social goals. Exports account for 14 percent and 22 percent of the GNP's of Japan and Germany, respectively, and some of our European trading partners export as much as 40 percent of GNP. The comparable U.S. figure is less than seven percent of GNP, and

*The deficit figure is for manufactures and commodities. It should be noted that the U.S. trade balance in services has been positive for a decade with a growing surplus that reached $22 billion in 1978. The service sector has only recently been recognized as a major factor in U.S. trade and merits greatly increased recognition in U.S. trade policy formation.

fewer than 200 firms account for more than 80 percent of U.S. manufactured exports.

The commercial policies of the major industrialized countries generally provide more export incentives (such as tax benefits, export promotion aids, and research and development grants) and maintain fewer disincentives than is the case in the United States, where the federal government traditionally has tended to underestimate the significance of export growth to domestic economic welfare. Thus, U.S. international economic policies and programs generally have been an ad hoc patchwork rather than a comprehensive, internally consistent approach. Disincentives undermine incentives, often confusing a would-be exporter to the point of deterring him from entering the international arena. Policies and regulations, in addition to being cumbersome and confusing, often conflict and tend to weaken U.S. competitiveness in world markets. While the cumulative effect of foreign government incentives is to make foreign exports more internationally competitive, U.S. policymaking has provided little encouragement to U.S. companies with a potential for expanding their markets abroad.

Thus, there is a need to enhance the competitive capabilities of existing exporters and to acquaint potential exporters with the benefits that accrue from international activity. In belated recognition of this need, President Carter on September 26, 1978, announced a series of measures designed to show his Administration's commitment to place a higher priority on exports. Though an important first step, the policies and program he announced are generally too short-term in focus and lacking in sufficient comprehensiveness to bring about significant export expansion. Because U.S. export deficiencies have evolved over many years, remedies must also be long-term in nature. Many of the recommendations included in this paper attempt to fill the need for a longer-term perspective.

Setting a target

Simply enunciating a policy for export expansion is not enough. Foreign governments frequently set export expansion targets to achieve public policy goals, and it would be useful for the U.S. government to adopt a similar approach. Admittedly, a target-setting exercise will be difficult because many factors other than export expansion programs affect a country's export capabilities.

Recent projections to 1982 indicate that world exports of goods and services will rise at an annual average rate of 13 percent, compared to an expected increase for the United States of not more than nine percent. In order to maintain current U.S. market shares of world trade and to help restore some balance to U.S. trade flows, export expansion policies and programs should contribute to closing the gap between expected U.S. and world export growth rates. This is a realistic and attainable goal, and adoption of the recommendations that follow can provide the synergism to achieve and, quite possibly, surpass this target.

EXPORT INITIATIVES FORM THE PRIVATE SECTOR

The role for private enterprise

For all that federal, state, and local governments can do to promote and facilitate export expansion—from the removal of disincentives to trade to the provision of specific incentives—the actual carrying out of export expansion rests with private enterprise. Given this bottom-line role in trading, private enterprise must share with government the responsibility for this country's unsatisfactory export performance. While private enterprise should continue its constructive criticism of government export programs, or the lack thereof, it must actively pursue foreign market opportunities. As government activity opens new or clears existing channels of trade, it is the responsibility of private enterprise to transform potentiality into actuality.

Much of the sluggishness in export expansion by private enterprise drives from a general naivety in this country about the significance of and benefits from exporting. This unawareness, which extends from the labor community to a broad segment of private enterprise, has resulted largely from an outmoded notion of economic self-sufficiency. The recognition of our economic interdependence has been too slow in setting in. This situation contrasts sharply with our major trading partners who for decades have depended upon and, therefore, ideologically internalized the need for exports.

Those elements of the private sector aware of and engaged in exporting have generally been uncommunicative about their international business transactions. Minimal informational efforts have been directed toward stockholders and employees, and many suppliers are often unaware that their component contributions are a vital part of an export product. Aside from the paucity of timely and adequate

international trade information, those enterprises with an export commitment generally view foreign markets as supplementary to domestic markets and, hence, tend to pursue markets abroad as a secondary line of business, once again in sharp contrast to our trading partners. This particularly apparent from overseas complaints that many U.S. firms fail to provide timely or adequate servicing of products. In addition, the follow-up potentials of service, replacement parts, and modification often go undeveloped resulting in complaints of unreliability and creating opportunities for foreign competition to take over.

Recommendations

Private enterprise must take the lead in fostering an export consciousness in the United States and must increase the U.S. presence in foreign markets. These twin goals can be accomplished in the following ways:

(1) Industry and agribusiness must actively educate their respective communities as to the importance of exports by using the following methods:

Identify the impact of export sales on the company and the community.

Inform employees and stockholders via annual reports, in-house newspapers, bulletin boards, staff meetings, and stockholder meetings of the importance of export sales to company jobs, profits, and growth.

Inform suppliers by special notice or by note on purchase orders if an item is to be a component of an export product.

Inform the community of its export stakes during presentations at meeting of local chambers of commerce, civic groups, farm organizations, labor unions, radio and television talk shows, etc.

Involve union leaders, congressional representatives, and the media in efforts to spur export growth.

(2) More industrial and agricultural firms should concentrate on export market identification and development and should avail themselves of foreign market studies prepared regularly by the U.S. Departments of Commerce and Agriculture and by state agencies.

(3) More corporate research and development should include ways to adapt products and services to foreign requirements. Operating and maintenance instructions should be provided in foreign languages, and firms should be prepared to quote prices in foreign currencies if necessary.

(4) Greater corporate resources should be devoted to promote exports and to ensure that deliveries are met, service maintained and warranty commitments honored.

(5) Firms should consider possibilities in joint ventures for exporting, such as: (a) joint marketing efforts by manufacturers in complementary lines; (b) smaller firms "piggy-backing" on larger, more experienced companies; and (c) joint bidding with complementary contractors and suppliers.

(6) Such organizational options as the trading company and Webb-Pomerene associations should be given greater consideration.

(7) Firms should develop their own marketing, distribution, and servicing channels in foreign markets, even if they do not manufacture in that market.

(8) All long-term profitable spinoffs of export transactions should be developed.

(9) Greater utilization should be made of farmer checkoffs* in cooperation with the Department of Agriculture to promote agricultural exports.

(10) Private enterprise should refrain from singling out exports for blame in times of domestic shortage and, consequently, from seeking regulations to curb exports unless national interest considerations clearly prevail.

Joint business/exonomic councils

Joint business councils are uniquely equipped to develop innovative approaches to trade expansion. These councils develop for government consideration policy and program recommendations which seek to establish a climate for the successful pursuit of U.S. economic interest *vis-a-vis* their counterpart countries, focusing particularly on areas of concern to U.S. firms interested in or actually doing business with those countries. The United States Chamber of Commerce currently sponsors 17 bilateral business councils with selected countries or regions, bringing together on a regular basis more that 500 U.S. senior corporate officials with their counterparts from Asia, Africa, Latin America, Canada, the Middle East, and Eastern and Western Europe. other joint councils not under the auspices of the Chamber are similarly suited to promote U.S. exports.

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*A checkoff is a voluntary levy on products contributed to promote mrket development and research.

Recommendations

Greater use should be made of joint business councils to further U.S. economic policies and programs abroad, particularly through the following instrumentalities:

(1) Councils should actively seek changes in U.S. and foreign government policies which unduly restrict the expansion of commercial relations.

(2) There should be more prominent involvement of U.S. council members in U.S. and state government export development efforts, both domestically and abroad. For example, council members become knowledgeable spokesmen on U.S. economic interests in selected countries, and their expertise should be used in leading or participating in trade promotion missions.

(3) Councils should consider the sponsorship or cosponsorship of certain trade missions and fairs.

(4) Private sector, bilateral arbitration or conciliation mechanisms, operating under the auspices of a council, can provide a quick, inexpensive, and effective way of resolving trade disputes.

(5) Councils should consider the funding of training or research programs in improve the climate for U.S. business activity abroad.

Trade associations and chambers of commerce

Business organizations which coalesce industry—specific and general business interests have a great potential for educating member firms abount international business transactions and for encouraging them to generate exports. In addition, these organizations, which include trade associations and local and state chambers of commerce, are natural partners with federal, state, and local governments for mounting joint export promotion efforts.

Recommendations

Trade associations and chambers of commerce should serve as catalysts to generate industry and region-specific exports.

(1) Commerce Department field offices and local and state chambers of commerce should increase cooperative efforts to assist exporters in expanding their foreign market activity and to encourage firms with an export potential to enter the field.

(2) Trade associations should develop and promote programs directed toward making their membership more aware of the opportunities in foreign markets for their products. In such efforts, trade groups should seek the support of government agencies such as regional or state departments which exist to attract business to a particular area.

American chambers of commerce abroad

American chambers of commerce abroad, now operating in forty countries, are voluntary associations of business executives concerned with U.S. trade and investment. These organizations work (a) to develop mutually prosperous and amicable economic, social, and commercial relations between U.S. business interests and those of host countries; (b) to foster and communicate abroad the beneficial concepts of U.S. private enterprise; and (c) to promote local economic and social contributions for the benefit of host countries. American chambers abroad are locally respected vehicles for encouraging the sale of U.S. products in their host countries.

Recommendations

American chambers of commerce abroad should expand their efforts to promote U.S. exports.

(1) American chambers abroad should promote in the United States the opportunities for U.S. products in their host country markets through their publications and in conferences and seminars.

(2) American chambers abroad should work more closely with U.S.-based firms and business organizations in joint efforts to enter and maintain markets in their host countries.

(3) Maximum cooperation should be sought between U.S. government commercial offices and American chambers abroad to develop and expand foreign markets for U.S. products.

(4) U.S. companies should as general policy encourage membership by their subsidiary agents or distributors in the American chambers in the countries to which they export or plan to export.

(5) U.S. companies interested in, but not yet represented in, foreign markets should be permitted and encouraged to maintain non-resident memberships in American chambers located in the markets in which they have an interest. Such an affiliation can be a valuable source of current information on the local economy and business conditions.

(6) American chambers should serve as centers to monitor trade problems, providing feedback to the U.S. Chamber for its development of international trade policy.

(7) American chambers abroad should serve as focal points for presenting trade issues before host governments.

A role for the United States Chamber of Commerce

As the country's largest and most broadly representative business organization, the United States Chamber of Commerce has traditionally been active in fostering the export interests of its members, focusing its efforts mainly on the policy environment that either encourages or constains export expansion. The Chamber has also sought to facilitate foreign demand for U.S. goods and services by encouraging foreign governments to reduce tariff and nontariff barriers that impact adversely on U.S. exports. In addition to strong support for the Multilateral Trade Negotiations, the Chamber has served as a catalyst for the establishment of a growing network of American chambers of commerce abroad and of joint business councils.

Recently, the Chambers International Division has strengthened and expanded its research, publications, and conference capabilities. Plans for 1979 call for the publication of a *Foreign Commerce Handbook*, an *Introduction to Doing Import and Export Business*, and various other publications to assist actual and potential exporters. Conference programs have included export finance seminars in various U.S. cities, and in 1979 the Chamber plans to sponsor a series of regional workshops designed to inform businesses on ways they can participate more actively in projects funded by international financial institutions. The Chamber's International Division has traditionaly provided referral and information services to exporters.

Recommendations

The Chamber must expand its efforts, particularly in the program, educational, and communication areas, to effectively serve the needs of the export community. Some of the initiatives that could be launched include:

(1) Export consulting services designed to assist small and medium-size firms to enter the export field should be provided.

(2) The Chamber should aggressively pursue the establishment of American chambers of commerce in countries where none exist and of additional joint business councils.

(3) Chamber publication and conference capabilities should be expanded to increase the flow and quality of information that can be targeted to would-be exporters.

(4) A research capability should be established in the Chamber to study how other countries encourage exports and whether such programs can be adapted to U.S. needs.

(5) Chamber interaction with the Congress and the Administration should increase in the development of an environment conducive to export expansion.

REMOVING U.S. GOVERNMENT DISINCENTIVES TO EXPORTING

In a highly complex and pluralistic socio-economic environment, it is inevitable that government programs and policies designed to address one area of concern will often be internally inconsistent with or will adversely impact on unrelated areas. This is precisely what has happened to the international trade environment in this country. Because international trade has been a low priority interest of the U.S. government for such a long time, efforts to expand exports have been impeded by inadvertent disincentives, ranging from the adverse consequences of regulations to ineffective government organization. What follows is an examination of the major disincentives to export expansion in the United States and recommendations for removing unnecessary constraints on U.S. exporters.

Government reorganization

Numerous government entities have international trade responsibilities, and each pursues its own set of fundamental objectives, which at times are at variance with the concerns of other agencies. To name a few, there are the trade promotion and control activities of Commerce; foreign policy and human rights responsibilities of State; revenue collection and monetary concerns of Treasury; credit and insurance services of the Export-Import Bank, Overseas Private Investment Corporation (OPIC) and the Commodity Credit Corporation (CCC); antitrust enforcement of Justice; disclosure requirements about marketing activities of the Securities and Exchange Commission (SEC) and Commerce; export controls imposed by Defense; and commodity responsibilities of Agriculture.

This proliferation of agencies and philosophies often results in confusion, delays and discouragement to export activities. There is clearly a need to simplify and

make more effective the governmental administrative structure for formulating and implementing U.S. international economic policy and programs.

There are three basic schools of thought on the reorganization of the government in the international trade and investment area. For some, the present division of responsibility for international economic policy among various agencies reflects checks-and-balances considerations that are fundamental to our democratic process. Others believe that a new department, a Department of International Trade and Investment (DITI), should be created to be the sole agency for formulating and implementing international economic policy. Still others believe that organizational improvements could be made by augmenting the international trade and investment functions of the U.S. Department of Commerce and other relevent agencies.

Recommendations

While the dabate on government reorganization continues, given the urgent need to generate exports, efforts should be made to strengthen, streamline, and make more effective existing governmental institutions. The Chamber is more than willing to assist the Administration in its analysis of government reorganization.

(1) The President should designate a cabinet level official with the responsibility and authority to coordinate and oversee the activities of the various government agencies and departments with international trade responsibilities.

(2) International trade, investment, and economic development responsibilities of pertinent government agencies and departments should be upgraded to higher levels of decision-making authority.

(3) The international trade and investment role of the Commerce Department should be expanded and strengthened.

(4) The international services sector requires specialized attention to bring it fully within the framework of U.S. trade and investment policy. This requires greater communication and coordination among existing government offices which relate to service trade. To accomplish the necessary interagency coordination, the establishment of an interagency committee on services chaired by the Department of Commerce is urged, as proposed in the 1976 White House Interagency Task Force study, "U.S. Service Industries in World Markets." In addition, the International Service Industry Division, recently established within the Department of Commerce's Industry and Trade Administration, should be strengthened.

(5) Greater coordination is needed between the foreign offices of U.S. state governments and federal government offices abroad.

Export-discouraging consequences of regulations

Governmental regulations intended to promote a diverse range of goals have frequently had a spillover effect hindering export expansion. The extraterritorial application of regulations in the following areas is particularly noteworthy for its discouraging impact on export expansion, and reevaluation is needed to determine if the policy benefits justify the costs in terms of lost export potential:

U.S. flagship requirements which prohibit Export-Import Bank financing for freight costs on foreign vessels, even when U.S. ships are not available;

Occupational Safety and Health Act requirements, Consumer Products Safety Commission standards, and Federal Drug Administration requirements which extraterritorially interfere with a foreign government's responsibility for the welfare of its citizens;

Pesticide regulations which exceed foreign government standards;

Unilaterally imposed human rights-related restrictions which, in the absence of internationally accepted ground rules, serve only to divert export sales to our competitors;

Environmental reviews which may limit export financing;

Those Freedom of Information Act requirements which can result in government disclosure of proprietary business information valuable to foreign competitors.

The President had directed all executive department and agencies and has requested independent regulatory agencies" to take into account and weigh as a factor, the possible adverse effects on our trade balance of their major administrative and regulatory actions that have significant export consequences." This beginning step needs follow-through to ensure that U.S. international trade and investment goals are not undermined by policies and regulations intended for altogether different purposes.

Recommendations

Export impact statements should be an integral component of all regulatory measures. In addition, the following steps should be taken:

(1) The President's directive lacks sufficient specificity to guide agencies in balancing the national export expansion priority against fundamental agency objectives. Specific criteria for review should take into consideration the differences between new-to-export and established export operations, variations in classes of exports (e.g., goods versus services), and varying company sizes and operating regions.

(2) An overview body should be appointed to evaluate all regulations impacting on international trade to ensure that there is a proper balancing of special interest objectives and the overall national priority of export expansion.

(3) Wherever feasible, regulations should follow universally accepted standards or conform with multilateral agreements.

(4) Agencies and departments should clarify the intended applications of their respective regulations. Often, the disincentive effect of a regulation lies as much in incertainty in the minds of many businessmen as to how the regulations will actually be applied as in their substance.

(5) Review of regulations for adverse export consequences should be an ongoing exercise, because competitive circumstances in international markets are constantly changing.

(6) Regulations which restrict nonsecurity-essential exports to accomplish a purpose unrelated to trade should be carefully limited. Unilateral constraints are generally not effective in changing the policies or behavior of other countries.

(7) Regulations must provide for a higher degree of long-term certainty, if the foreign buyer's view of the United States as an unreliable supplier is to be changed.

(8) Restrictions imposed on U.S. exports under the President's foreign policy authority in the Export Administration Act have retarded exports to South Africa, Argentina, Libya, and many other countries. Generally, the foreign policy goals have either not been met or have been of a relatively short-term nature.

There are instances when swift implementation of an export control is needed to achieve a vital foreign policy goal. Nonetheless, the Export Administration Act should be amended to ensure that the legitimate foreign trade interests of the United States are not impaired unnecessarily. The following amendments to the Act would accomplish this objective:

In emergency circumstances, the President may impose a unilateral foreign policy export control but only for a period of 90 days. Congress may disapprove the use of such controls after the initial 90-day period.

The President should submit to Congress at the time such controls are proposed a report indicating clearly the foreign policy objective sought, a description of how the control will achieve that objective, an economic impact statement with an employment impact analysis, and an explanation of measures undertaken to obtain multilateral support for the controls.

Aside from emergency situations, the rulemaking procedures of the Administrative Procedures Act should be made applicable to the imposition of such foreign policy controls.

Export licensing

The approval time for export license applications is often so slow as to harm U.S. competitiveness in world trade. The United States is viewed as an unreliable supplier by many foreign buyers because transactions have been hampered or blocked as a result of delays and confusion in obtaining U.S. export licenses. By way of example, U.S. companies recently lost a commitment from the Soviet Union for equipment purchases worth $225 million because the U.S. export licenses were delayed beyond the Soviet's patience; the contracts were finally awarded to French concerns.

Recommendations

(1) The Export Administration Act should stress the desirability of international trade, to the extent of changing the ability to engage in trade from a privilege to a right.

(2) Export license restrictions should be used only for essential security reasons and not for other political purposes.

(3) An effective procedure for the determination of foreign availability of comparable products and technology should be established by the Commerce Department. Foreign availability should create a presumption in favor of license application approval.

(4) Greater transparency should be afforded to exporters so that they can ascertain the status of their cases, talk to the parties holding them up, and thus speed decisions.

(5) Instead of applying a time limit on issuing export licenses, an export license should be automatically approved if not specifically disapproved within 30 days of submittal.

(6) The Export Administration Act should be amended to require validated export licenses only for commodities that are controlled multilaterally (COCOM).

(7) Whatever time is set for license review should not be frustrated by an announcement that further time is needed for consideration.

(8) The Export Administration Act should be amended to include provisions which would automatically take difficult cases out of lower level review after a certain period of time and raise them to higher levels so that decisions can be reached more promptly.

(9) The Commerce Department should seek a greater range of responsibility in the licensing area and should use more aggressively its ability to make the final decision on licensing.

(10) A denial of an application should be accompanied in writing by a detailed reason for the denial, and specific procedures for appeal in the case of denial should be established. If exports are denied for reasons other than essential security, the economic consequences of the denial should be published.

(11) On COCOM matters, the Department of Defense and State should allow private sector advisors to make a continuing contribution to the negotiations.

(12) Commerce Department's extraterritorial licensing requirements over U.S. commodities re-exported by other COCOM member countries should be eliminated.

Restrictions on trade with nonmarket economics

The nonagricultural export potential of the United States with countries with nonmarket economics (NME's) has gone largely unfulfilled. Where once the policies of both the Western countries and the NME's mutually constrictred trading relations, the past decade has seen a significant growth in trade between the NME's and our trading compeititors. For example, in 1977 the Federal Republic of Germany exported over $2.5 billion worth of nonagricultural products to the Soviet Union, the Japanese nearly $2 billion, and France and Italy between $1 billion and 1.5 billion each. The comparable figure for the United States is less than $600 million. Total exports for 1977 to the People's Republic of China from the Federal Republic of Germany reached $480 million, from the Japanese 1.9 billion, and from the United States $171 million.

Of the world's NME's, the United States has normalized trade relations only with Poland, Romania, and Hungary. This is in sharp contrast to the relations that exist between our trading competitors and the NME's. The competitive advantage our trading partners have over the United States in trade with the NME's will continue as long as we persist in withholding most-favored-nation treatment until the NME's give certain nontrade-related concessions. U.S. exporters are further disadvantaged because U.S. government financing facilities are not fully available to some of the most important of the NME's, while our trading competitors are not similarly restricted.

By way of example of the problems arising for an exporter interested in NME markets, consider this country's recent recognition of the People's Republic of China. The long-term potential for U.S. exports to that country is immense, and the Chinese have indicated a great interest in purchasing U.S. equipment and technology. However, in order to purchase from the United States, the Chinese must be able to sell profitable in this market in order to generate purchasing capital and must be able to obtain financing for its purchases. Existing discriminating tariffs inhibit the former, and export-financing legislation prohibits the latter.

Recommendations

Trade parity for the NME's in the form of stability and nondiscriminatory treatment is needed in U.S. trade expansion efforts.

(1) The Jackson-Vanik Amendment, linking the extension of nondiscriminatory most-favored-nation tariff treatment and U.S. export credits with free emigration, should be repealed or modified.

(2) Those provisions of the Export-Import Bank Act, as amended, that limit Eximbank credit availability to the Soviet Union should be repealed.

(3) The Administration should adopt a strong position favoring expanded trade with the NME's in products and services not essential to the security interests of the United States.

(4) The Administration should pursue, where appropriate, bilateral agreements with NME's which would clear trading channels.

Antiboycott regulations

The U.S. response to international boycotts is comprised of a confusing set of policies, laws, and regulations: the Export Administration Act (EAA) amendments of 1977 and the related Commerce Department regulations, the Ribicoff antiboycott

amendment to the Tax Reform Act of 1976 (Section 999), and whatever further judicial proceedings and conclusions result from the suit brought against Bechtel Corporation* by the Justice Department. The complexities of the U.S. antiboycott laws and regulations and the comparatively short time frame in which they have been in effect make it difficult to appraise their impact upon export expansion to the countries participating in boycotts. This complexity plus the certainties of further interpretations of the laws and regulations may well inhibit both U.S. exporters and importers of U.S. goods in boycotting countries from expanding their trade activities.

The proper scope of antiboycott provisions of U.S. law is to prevent the extension of the effects of foreign boycotts into U.S. domestic commerce or the commerce of the U.S. with nations other than boycotting nations. To the extent that the provisions of the EAA accomplish this, they represent legitimate objectives of our government. There are, however, provisions which may create problems in the future.

Recommendations

Although more experience is needed with the antiboycott laws before their full effect can be measured, the following areas should be carefully monitored to ensure that the potentially harmful effects of the legislation do not exceed the Congressional intent to protect U.S. persons from discriminatory boycotts.

(1) The ban on providing information, apart from raising difficult constitutional questions, is an obstacle to firms seeking removal from existing blacklists, to firms threatened with inclusion on a blacklist, and to firms without existing business dealings with boycotting countries which seek to enter those markets. (The EAA may have a harmful long-term impact on American exports by causing U.S. trade with boycotting countries to be limited to companies already established in those markets. As new market opportunities in those countries arise, they might be met by exports from non-U.S. sources.)

(2) The extraterritorial application of the law has already posed problems in the relationships between foreign affiliates and their host governments, and these are likely to increase as the EAA's export-constraining effect on these affiliates becomes more apparent.

(3) The ban on negative certificates of origin conflicts with other provisions of the EAA which acknowledge the rights of countries to conduct primary boycotts against other countries and which permit American firms to respect the policies of those countries regarding such primary boycotts.

(4) The reporting burden imposed by the law raises the cost of American products in international markets, reducing export competitiveness, and often deterring companies from attempting to establish themselves in Arab markets.

Beyond these considerations, the following actions are specifically recommended:

(5) The negative effects of Section 999 should be carefully determined by those affected by it with a view toward a reevaluation of its impact along with the impact of the EAA on U.S. trade expansion.

(6) The Justice Department should withdraw its suit against Bechtel Corporation, because, if it prevails, behavior fully consistent with the EAA may be found to violate U.S. antitrust laws.

(7) Since the antiboycott provisions of the EAA have not been in force long enough to permit an accurate assessment of their effect, changes in the near term would be premature. If future developments warrant, however, the EAA should be amended to permit the provision of otherwise publicly available information, to circumscribe the extraterritorial reach of the law, to eliminate the prohibition on negative certificates of origin, and to simplify reporting requirements. These steps would be consistent with the law's intent while eliminating several potentially negative features.

(8) The Executive Branch should closely monitor the effect of the EAA on U.S.-Middle Eastern trade relations and take whatever steps become appropriate to limit the unintended side effects of antiboycott legislation.

(9) Private firms should keep records of economic losses attributable to the antiboycott laws which can serve as a reference in later reexamination of the laws.

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA), signed into law on December 19, 1977, instantly gave rise to interpretive problems for companies engaged in transactions abroad. As a consequence, the President in his export policy statement of September 26, 1978, directed the Justice Department to provide guidelines concerning its enforcement priorities under the law.

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* *U.S.* v. *Bechtel Corporation,* Civil No. C 76 99 (1978).

The majority of companies expressing opinions about the Act do not anticipate serious problems under sections 103 and 104; however, all claim some degree of difficulty in interpreting the Act and a few cite specific examples of lost business because of uncertainty about the Act's applicability. Problem areas include:

The extent to which a parent corporation will be held accountable for the actions of its overseas subsidiary, even though the subsidiary is not directly covered by the Act;

The extent to which U.S. companies will be held accountable for acts of their overseas agents and the standards that will be applied with respect to the employment and retention of agents;

The availability of the defense of physical or economic extortion, which is unlikely to prevail with respect to the obtaining of a contract (on the theory that one need not enter into a contract), but which must have some validity in certain situations with respect to the retention of a contract;

The interpretation that will be given the "grease" or facilitating payments exemption;

How the Fraud Section of the Justice Department, which is given both criminal and civil jurisdiction under the Act, will administer the civil process.

Recommendations

The United States Chamber of Commerce does not condone corrupt business practices in any form. The FCPA does, however, create the situation where U.S. businessmen are prohibited from engaging in certain practices that are freely pursued by our trading competitors. In administering this Act, the Justice Department and the SEC should take cognizance of the competitive disadvantages created and should provide needed elements of certainty.

(1) The consensus is that more time is needed for an FCPA experience to develop before the business community can constructively contribute to decisions on guidelines.

(2) In the meantime, the conclusion of bilateral and multilateral agreements among the largest possible number of industrialized and developing countries would establish standards of ethical and equitable conduct of international business, provide that these same standards would apply to competing businesses, and would establish a mechanism to resolve the diplomatic, commercial, and legal problems associated with such practices.

(3) For the present, the most serious difficulties for business under the Act are to be found within section 102, the accounting standards provision. This section is not limited to foreign bribery, but extends to virtually all publicly held companies within the jurisdiction of the SEC. The cost-benefit relationship for an internal control system is clouded by the enforcement and legislative environment in which the Act evolved. The SEC should make clear its enforcement priorities, keeping in mind the cost to business of this section of the FCPA.

(4) The Justice Department should make available its Business Review procedure for guidance in areas of uncertainty under the FCPA.

(5) The U.S. legal community should begin to develop a record of experiences under the Act to serve as a guide to the business community.

The imbalance between U.S. and foreign antitrust laws

The United States is the only country in the world that imposes its domestic antitrust restraints upon its exporters and overseas contractors to prevent them from combining for sales outside of its national borders. The extraterritorial extension of U.S. antitrust laws is widely believed within the business community to weaken the competitive position of U.S. business in international markets and is increasingly viewed by foreign governments as an infringement on their national sovereignty. In many instances U.S. antitrust laws have reached into foreign countries even when there has been no significant impact from international commerce upon U.S. domestic commerce.

The Department of Justice has consistently maintained that U.S. antitrust laws do not deter legitimate export transactions. However, a comparison of national antitrust laws leaves little doubt that U.S. antitrust laws are more inhibiting than those of our trading counterparts. This conclusion is further reinforced when, as has recently happened with many of our trading partners, a foreign government complains that U.S. antitrust laws are being applied within its borders beyond the scope of its own antitrust laws.

Competitive conditions in international transactions often necessitate a pooling of complementary skills or assets. Yet, U.S. antitrust laws have largely discouraged such combinations or joint ventures. Consider, for example, the permissibility under

Japanese law of a consortium of bidders for a contract; U.S. law prohibits similar action.

The President in his national export statement instructed the Justice Department, in conjunction with the Commerce Department, "to clarify and explain the scope of the antitrust laws" in U.S. export trade. However, given the past export-discouraging history in this area and the recent attempts at greater extraterritorial reach, it is clear that something more than clarification is needed. There must be some changes made in underlying philosophies and objectives.

Recommendations

(1) The United States should seek multinational harmonization of antitrust laws for the purpose of avoiding the imposition of conflicting judicial and regulatory requirements on the separate components of multinational enterprise.

(2) The Justice Department should recognize that there is often greater need in overseas transactions to enter into joint ventures to meet competition, because of greater risks and greater need to pool resources, than in domestic transactions.

(3) When actions are taken under the antitrust laws, distinctions should be made between domestic and foreign transactions, with a less restrictive standard for the latter.

(4) The Justice Department should respond in a more timely fashion to requests for guidance from the business community. The recent commitment to issue business review letters on export trade within 30 days is a good step in that direction.

(5) U.S. antitrust laws should never have an impact on business operations in a foreign country greater than the impact of that nation's own antitrust laws. The Justice Department should consult with other countries before getting involved in business transactions outside of the United States.

The Webb-Pomerene Act

The 60-year-old Webb-Pomerene Act, which exempts trade associations from the Sherman Act if they do not lessen competition in the United States, is a potentially useful export promotion vehicle. The Act was initially intended to allow U.S. exporters to compete on a more equal basis with foreign cartels in overseas markets. However, statutory vagueness has resulted in underutilization of the Act, and administrative and judical rulemaking has done more to restrain than advance the intent of the Act. If the original intent of the Act is legislatively and administratively restored, the Act could serve a useful role in export expansion, especially for small and medium-size companies interested in bidding on large foreign contracts.

Recommendations

(1) The Act should be rewritten so as to remove statutory vagueness.

(2) The definition of "export trade" should be broadened to include services, such as those related to architecture, engineering construction, training, finance, insurance, and project or general management, as well as know-how incidental to the sale of goods, wares, merchandise, or services.

(3) The Commerce Department should be responsible for educating the business community about and promoting Webb-Pomerene associations. Commerce should also establish a liaison with the Justice Department, seeking guidelines consistent with their promotional activities.

(4) Sales by export associations through government agencies should be explicitly permitted. (*United States* v. *Concentrated Phosphate Export Assn.*, 393 U.S. 199 (1968), proscribed association participation in AID-financed projects.)

REMOVING FOREIGN BARRIERS TO EXPORTING

The viability of an export expansion program is affected both by domestic and foreign barriers to trade. The export-generating effects of the "Tokyo Round" of the Multilateral Trade Negotiations (MTN), which focuses on triff reductions and non-tariff barriers to trade, will be a function of the implementation and enforcement of the agreements. Even when fully implemented, the MTN will not have removed a variety of restraints to trade.

Tariff barriers

Formerly the major government-imposed barrier to trade, tariff levels have been reduced in a succession of multilateral trade negotiations to the point where in most cases they are no longer as significant a barrier as the variety of nontariff measures. The average tariff rate for the industrialized countries is approximately eight percent. However, this average masks wide variations in the highest and lowest rates.

The current "Tokyo Round" of the Multilateral Trade Negotiations aims to reduce existing tariffs by a trade-weighted average of approximately 33 percent over the next eight years, as well as to harmonize some of the wide spreads in current rates. The new tariff agreement is expected to go a long way toward reducing the remaining negative effect of tariffs on trade flows, but it will by no means eliminate tariffs. Most countries will be taking exceptions to the basic tariff-cutting formula, particularly for import-sensitive products where they feel protection is most needed. Even very low tariffs can make the margin of difference in highly competitive markets.

Recommendations

In the coming years, further tariff reductions should be encouraged on the part of all countries, but especially by some of the more successful developing nations which can afford to give up a measure of the protection they maintained during the development process.

Nontariff barriers

In most foreign markets, nontariff barriers (NTB's) are greater impediments to the export of U.S. manufactures and commodities that are tariffs. NTB's are the principal foreign trade barrier of the exports of U.S. service industries. The following categories of NTB's have been the subject of negotiation in the durrent Multilateral Trade Negotiations (MTN), where the objective is to reach agreement on international codes of behavior to govern the use of NTB's: Subsidies, safeguards, standards government procurement, customs valuation, licensing, and commercial counterfeiting.

Until these negotiations are completed, a comprehensive appraisal of their effectiveness in facilitating U.S. export expansion cannot be made. However, based on the negotiating texts available at this time, it is expected that significant barriers to U.S. exports of manufactures and commodities will be removed or reduced. Much less progress is expected in reducing barriers to U.S. service industry exports, and certain NTB's, such as border taxes, will not be affected by the negotiations. In addition, as a growing number of developing countries (LDC's) make advancements in their development, trade barriers used to protect so-called "infant industries" will cease to be justifiable.

Recommendations

The recommendations which follow assume that MTN will be completed and adopted by the United States. Much of the final impact of the codes will depend on how well they are implemented and enforced.

(1) The United States should carefully monitor code enforcement.

(2) Consideration should be given to the expansion of the codes into areas not covered and to countries not participating in the MTN.

(3) Multilateral and bilateral efforts to remove foreign barriers to U.S. exports not affected by the MTN should continue. The following remain relatively untouched by the MTN, but need serious attention:

(a) There are many complex foreign tax practices that impede or unfairly handicap U.S. exporters.

(b) A broad range of foreign government interventions in support of export efforts will remain as a major and undoubtedly evolving disincentive to U.S. exports. This includes state-trading activities and the nationalized (or indirectly-controlled) industries of market economy countries, together with the non-financial preferences and assistance accorded them. It also includes, in some instances, policies restraining establishment of sales and service facilities necessary to establish or expand imports from the United States and, in other instances, minimum import price regulations or unreasonable local content regulations.

(c) Many policies affecting agricultural exports will not be resolved by the MTN. For example, while quota levels may be raised for some agricultural products, few quotas will be lifted entirely and many will remain highly restrictive. Continuing multilateral and bilateral efforts will be require to obtain greater foreign market access for U.S. agricultural exports.

(d) Specialized efforts through multilateral or bilateral means will be necessary to address the NTB's which hamper U.S. service industry exports.

GOVERNMENT PROGRAMS TO ENCOURAGE EXPORTS

In order to encourage export expansion, the removal of domestic and foreign constraints to trade must be buttressed by government policies and programs designed to facilitate the entry of U.S. exporters into world markets. Government assistance can be particularly valuable for small and medium-size firms which lack

the resources and experiences of larger companies to develop international business opportunities. The export potential of all firms, in terms of both entry and expansion, can be tapped by providing tem with specific tools of trade and a better trade environment.

Tax neutrality

Ideally, in a free trade world neither tax incentives nor disincentives would be used to affect the flow of goods between countries. However, a multitude of tax systems specifically designed to increase exports are in use throughout the world, some countries having much more extensive export-related tax systems than others. Some systems are considered acceptable by the international community, while others are not. For example, the General Agreement on Tariffs and Trade (GATT) does not consider the European value added tax (VAT) rebate to be a subsidy, even though it is rebated directly to the exporter. On the other hand, the U.S. Domestic International Sales Corporation (DISC) is questioned, even though it simply defers a tax and does not constitute an exemption from or a rebate of a tax.

In the absence of universally accepted and applied rules governing the use of tax systems to promote exports and given the likelihood that many countries will continue to provide special tax treatment for their exports, the United States should use its tax laws to stimulate exports. Rather than tax incentives, however, the concept of tax "neutrality" should be used to place the U.S. exporter in the same tax competitive position as his major trading partners. U.S. tax policies and procedures should parallel the GATT-accepted competitive advantages that our trading partners receive through their national tax codes.

Domesticaly, tax measures to encourage export expansion should be structured to assist a wide range of existing and potential exporters. The Administration has expressed that small businesses have not benefited sufficiently from existing incentives for exports. Thus, future efforts should apply equally to small and large companies.

Recommendations

(1) DISC/VAT. In a free trade world neither DISC nor VAT should be use to promote exports. However, as long as the VAT system, is used by other countries, the U.S. should retain DISC in order to maintain a degree of competitiveness.

(a) DISC: This export aid has been used by approximately 10,000 firms. However, changes in the Tax Reform Act of 1976 and restrictive IRS rulings have eroded the incentive potential of DISC. In redressing the problem, the major stress should be on trying to clarify DISC with specific IRS Rulings and amendments to the Act. Moreover, emphasis should be placed on reasonable administration of tax laws rather than frustrating the Congressional mandate through overly technical administration of the law. In addition, long-term certainty must be provided, for DISC's uncertain future has in itself been a disincentive to its use.

(b) VAT: In the European VAT system, all accumulated indirect taxes are rebated to the exporter. This gives a foreign exporter a clear competitive advantage over his U.S. counterpart. One way to correct this imbalance might be to create a U.S. equivalent VAT which would, inter alia, rebate to the exporter an amount equivalent to the VAT type taxes on a U.S. transaction on a specific export. Substitution of such a tax for a portion of existing U.S. taxes could equalize tax consequences on export between the U.S. and those countries with a VAT. Such an approach needs to be thoroughly researched in order to present a practical proposal to the Congress. It is a proposal which, while GATT might disapprove of it as a subsidy, might also be an equivalent to what is now approved by GATT.

(2) "Deferral", No other country in the world taxes its shareholders on the profits of foreign subsidiaries unless and until those profits are paid to the shareholders. If the United States eliminates the current system of taxing the earnings of U.S. controlled corporations only after they are paid to the U.S. shareholders as dividends, U.S. subsidiaries abroad will be burdened by higher operating costs than their competitors. Since some 30 to 40 percent of all U.S. exports are sent to U.S. controlled affiliates, elimination of the present system would seriously jeopardize U.S. export competitiveness. In short, the current system should be maintained.

(3) Foreign Tax Credits. The purpose of foreign tax credits is to prevent double taxation. Without such credits operating costs are increased and, consequently, competitiveness is lowered. There is a definite need for recognition in the administration of U.S. tax law that foreign taxes reasonably intended to tax income are creditable income taxes. Unfortunately, businessmen are current without guidelines on various across-the-board problems in this area. In developing the much needed guidelines, the IRS should survey businesses to gain an understanding of the practi-

cal problems exporters have in trying to cope with the tax policies of specific countries.

(4) Tax Treaties. The Department of Treasury should continue to develop bilateral income tax treaties for the avoidance of double taxation. The United States should pursue its policy of limiting tax jurisdiction of treaty partner countries on export income through restrictive definitions of what constitutes taxable permanent establishments and by limiting the jurisdiction of foreign countries to tax services on fees related to exports.

Bilateral treaties should also be negotiated to avoid double payment of U.S. and foreign social security taxes by U.S. employees working abroad who will never receive social security benefits from the countries in which they are working. Congress has authorized the President to enter into bilateral social security agreements. Agreements have already been reached with the Federal Republic of Germany and Italy to the effect that U.S. employees in Germany and Italy only pay U.S. social security taxes.

(5) Taxation of U.S. Citizens Working Abroad. U.S. tax laws on foreign earned income should encourage, rather than discourage, U.S. nationals to work abroad. U.S. citizens and firms abroad are essential agents for promoting U.S. exports. Given the increasing economic difficulties facing Americans working overseas, this area of the tax law must adapt to the times so as to enable U.S. citizens and businesses to become more competitive with their foreign counterparts.

(6) Harmonization of Tax Laws. Multilaterial negotiations should be undertaken to harmonize all export-related tax laws.

Competitive export financing

In a world where comparable products, services, and technologies are widely available, the terms of financing may be the persuasive factor in securing an export market. Until the recent expansion of the Export-Import Bank's (Eximbank) authority by the 95th Congress, the United States was at a marked competitive disadvantage in export financing vis-á-vis its trading partners. The new legislation, together with Eximbank's stated commitment to be competitive with its counterparts abroad, should enhance U.S. export competitiveness.

For agricultural products, both Public Law 480, under which the United States extends concessional dollar credits to LDC's unable to finance their imports through commercial means, and the general export credit sales programs of the Commodity Credit Corporation have played effective roles in export expansion. The recent addition of intermediate credit terms for agricultural commodities and the extension of limited credit to the People's Republic of China should also enhance U.S. export competitiveness, as should the Administration's stated commitment to strengthen its agricultural export policy.

Recommendations

The following proposals go further to bring Eximbank financing to the level needed to ensure sufficient export expansion to correct to the U.S. trade deficit. The first four will require additional legislation, while the remainder should be within Eximbank's current authority.

(1) Eximbank capitalization should be increased and more funds should be allocated for credit to "higher risk" developing countries and for matching foreign "mixed credits."

(2) There should be a relaxing of Eximbank's limitations on foreign content financing.

(3) Although Eximbank should be financially sound, export competitiveness, and not increased profits, should be the Bank's primary objective.

(4) Eximbank should not be subjected to politically motivated, nonfinancial considerations in the administration of its export support programs.

(5) Local cost financing should be supported up to the amount of the down payment.

(6) Financing terms of capital goods should be tied to the useful life of the product involved, the measure of useful life to be consistent with international financial practice.

(7) Eximbank should provide comprehensive guarantees on commerical bank participation in project financing when the commerical banks will provide competitive fixed rate quotes.

(8) Eximbank should makes its Bank Guaranty Program available to the exporter, the exporter's captive finance corporation, or any other financial institution.

(9) Eximbank should make its discount loan rates comparable to its direct loan rates in order to help small and medium-size companies compete for export sales.

(10) Eximbank should eliminate the arbitrary discrimination in the Discount Loan Program which limits the U.S. bank spread to one percent, since no such limitation is imposed upon foreign banks under the Cooperative Financing Facility (CFF) Program. (At the very least, Eximbank should issue an interpretation that it will not question a spread between the note rate and the discount rate so long as it does not exceed a one percent spread plus the equivalent FCIA fee for the transaction.)

(11) Eximbank should establish foreign regional offices to gather information about competition and foreign recipients of Eximbank financing; this would diminish the turn-around time for decisions on financing.

(12) Eximbank should participate in joint financing on guarantee schemes with foreign agencies, such as the U.K.'s Export Credits Guarantee Department, on a pari passu basis.

(13) Exambank should eliminate obstacles to gaining commitments on a timely basis, with an emphasis on streamlining documentation requirements.

(14) There is a need to meet foreign competition in the use of "mixed credits" perhaps through an AID/Eximbank interaction.,

In improving export financing of agricultural exports the following measures should be considered:

(1) Repayments of government financing of agricultural sales should be used for funding market facilities that promote U.S. agricultural exports.

(2) Export credit programs must continue to adjust as new conditions dictate. (For example, the recent extension of certain limited terms of credit to the People's Republic of China.)

Insurance is an important part of the export financing package, and another area for creating a competitive edge. The following changes for the Foreign Credit Insurance Association (FCIA) would further the goal of export expansion:

(1) FCIA should revise its burdensome claims procedures, to reduce the associated paperwork requirements and the protracted recovery periods.

(2) FCIA should eliminate obstacles to gaining commitments on a timely basis, with an emphasis on streamlining documentation requirements.

(3) FCIA (and Eximbank) should develop comprehensive lease insurance programs that realistically reflect the growing tendency of companies to acquire expensive equipment through leasing arrangements.

(4) FCIA should cover interest on defaults up to the Eximbank discount rate plus one percent so that the exporter can recover the cost of his investment.

(5) FCIA (and Eximbank) should restructure the "Switch Cover" Program to make it useful to a broader range of capital goods exporters; higher coverage limits are necessary for most industries.

International harmonization of export financing

U.S. exporters are often at a competitive disadvantage because our major trading partners have the benefit of more liberal government backed financing for export transactions. Areas where our trading partners gain a financing advantage include mixed credits, exchange rate fluctuation insurance, inflation indemnity, foreign content insurance coverage, local cost financing, and less restrictive country and credit risk analysis.

Eximbank has only been able to go part of the distance in closing the competitive gap. The following two examples are illustrative of the problem:

A $20 million sale to one of the Malaysian electric authorities was lost to a Japanese supplier.

(a) U.S. supplier with Eximbank support offered 100 percent financing on terms of 15 years at 7.5 percent.

(b) Japanese supplier offered 100 percent financing on terms of 20 years at 4 percent.

The U.K.'s Export Credits Guarantee Department (ECGD) has financed 100 percent of the contract value of aircraft even though the British content was only approximately 25 percent.

To the extent that Eximbank cannot be made more competitive through domestic legislation, bilateral and multilateral agreements are necessary to bring U.S. and foreign financing and insurance terms and rates within a tighter circle of comparability. In April 1978, an international agreement was reached to define export financing provisions. The agreement was only voluntary and does not cover practices such as mixed credits, ancillary insurance schemes, or the financing of certain products. Congress has instructed the Secretary of the Treasury and Eximbank to raise to the ministerial level negotiations to end predatory financing arrangements.

Recommendations

(1) The present International Arrangements as agreed to by the OECD members should be ratified by treaty.

(2) The base of participants in the International Arrangements should be expanded to encompass developing countries entering the export market.

(3) Certain special product sectors, such as commerical jet aircraft, should no longer be excluded from the Arrangements.

(4) Standards governing minimum interest rates, maximum repayment terms, informational exchange, appropriate sanctions applicable to violating nations, and the minimization of officially supported export credits should be established.

(5) Where multilateral agreements are ineffective, the United States should seek out bilateral treaties which end predatory financing.

Technical assistance in marketing abroad

Americans must be made cognizant of the importance of export expansion to the health of the domestic economy. Once this awareness sets in, the new export consciousness must be aided and guided, as the governments of other exporting nations do. The Departments of Commerce, State, and Agriculture have key roles to play in promoting export awareness and in the follow-up of providing technical assistance in marketing abroad.

Recent Commerce Department estimates reveal 20-30,000 companies in the United States which could, but have chosen not to, export; most are smaller companies. Special assistance must be targeted to small and medium-size business if this export potential is to be tapped, because the complexities of international trade are of greater magnitude for smaller businesses than for their larger counterparts.

Exporting often places severe strain on a company's cash flow and working capital, because of increased costs and longer pay-back periods. This generally impacts more substantially on a small company, where current cash flow is an operating necessity. Where a larger company has international exposure, a small company is often unaware of opportunities abroad. In addition, small companies are generally unfamiliar with the variations in trading practices abroad and on where to make contacts. A large company is more likely to have had experience in international markets and, if not, to have the financial resources to adequately investigate opportunities. These are but some of the special problems for small and medium-size business that must be overcome in order to encourage their entry into the export market.

Recommendations

(1) Most marketing promotion programs have not reached smaller businesses and, generally, appear to be used by firms already involved in exporting. Therefore, awareness programs and technical assistance should be directed at small and medium-size firms which, unlike their larger counterparts, do not have the resources to venture into the uncertainties of foreign markets.

(2) Until a U.S. export consciousness is firmly established, concentration should be placed on assisting new-to-export companies, the idea being that once a company tastes the profits of exporting it will be more self-reliant in pursuing foreign markets. In this pursuit, information regarding the following must be provided to U.S. firms with export potential:

The mechanics of exporting.

Sources of financial and technical assistance.

Appropriate markets and their laws and trade customs.

Potential customers.

Agents and distributors.

Promotional requirements.

Adapting products to foreign needs.

The above information should initially be product specific, and where federal resources permit, company specific. Generalities will not be persuasive to export-naive firms. The Commerce Department should be certain that such efforts reach beyond the port cities of the United States and that its foreign market studies are worldwide.

(3) Foreign markets need to be made aware of U.S. goods. Overseas product exhibitions, Trade Centers, and Trade Missions have proven useful in this area, but there is room for growth and improvement. It may prove useful to bring potential foreign customers to the United States. This would be particularly attractive to small businessmen who have neither the time nor the resources to travel abroad.

(4) Adequate funding for marketing promotion programs should be assured.

(5) Consistency in assistance programs must be maintained. Exporters must feel secure that assistance will be there until they are able to stand on their own. There

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is also a need for better coordination between the Commerce Department, its district offices, and overseas missions. Finally, communications with exporters must be timely, and promotion programs should be readily adaptable to meet changing private sector needs.

(6) Commercial offices in the embassies should be upgraded by providing training for a professional corps of commercial attaches. There is also a need for greater expertise in Commerce's domestic field offices and a tighter link with commercial offices overseas.

(7) The export promotion programs of the Department of Commerce and the overseas export promotion programs carried out cooperatively by the Commerce and State Departments have not devoted adequate resources to the promotion of U.S. services. Greater priority should be given to this sector, and financial and manpower resources should be made available for this purpose. Efforts should also be made to increase awareness of service exports by government trade promotion specialists in Washington and in U.S. embassies, consulates, and overseas trade centers.

(8) With the improvements to technical assistance suggested above, the Commerce Department can supplement its well-established staff, program, and field access to become a more effective single source of export assistance to small business. Commerce should be authorized to set up a $100 million revolving loan guarantee fund to be administered by Eximbank. Thereafter, Small Business Administration export assistance efforts should be redefined so that SBA will only refer export clients to Commerce and continue its broad advocacy role for small business.

(9) Expansion and improvement is necessary with regard to data on trade in services, as present information is general in nature and incomplete. Hence, it is difficult and in some instances probably impossible to evaluate the economic impact of trade policy options in the service sector. A systematic evaluation of present efforts for collecting service trade data is urged and a government working group on international service data should be formed promptly for this purpose.

Bilateral trade agreements

The United States has 43 comprehensive commercial treaties now in force, ten of which are with devoloping countries. The last of these Treaties of Friendship, Commerce and Navigation (FCN) was concluded in 1968. A 1977 General Accounting Office (GAO) report has recommended that bilateral investment treaties be sought with developing countries with potential for U.S. investment and that these FCN's should emphasize protection of private foreign investment.

Some European nations have recently negotiated an extensive network of bilateral investment treaties. The United States is presently negotiating with Singapore for such a treaty with a new provision for consultation if there are adverse effects on one side's national interest.

In the case of nonmarket economies, bilateral trade agreements provide the all-important political framework for a stable trading relationship. Beyond the political fremework, bilateral trade agreements offer important safeguards against expropriation, provisions for the establishment and maintenance of trade representations, and provisions for the facilitation of travel and access to end-users. Only Hungary and Romania of the nonmarket economies have bilateral trade agreements with the United States.

Recommendations

(1) When a country or topic cannot be brought within a multilateral framework, the use of bilateral treaty protection and assistance for U.S. foreign investment should be encouraged. Consideration should be given to broadening the scope of agreements to include provisions which may assist noninvestment trade relationships.

Bilateral trade agreements have proven useful to U.S. exports in their trading with Romania and Hungary. It is possible that some of the trade-related benefits deriving from the agreements with these two nonmarket economy countries could be parallel in other bilateral trade and investment agreements, particularly with non-communist countries with a high degree of state control and central planning. Such agreements, however, should exclude cargo preference arrangements.

(3) Consideration should be given to the extension of export credits for agricultural commodities to non-market-economy countries, either legislatively as was done with the People's Republic of China or by presidential determination as in the case of Hungary.

Research and development (R. & D.)

Federal expenditures in constant dollars for research and development have been declining over the last ten years, and of the R. & D. funds only 30–40 percent are

channeled into civilian research efforts. Meanwhile, many or our trading partners have been increasing their R. & D. efforts. As a consequence, the competitive advantage of the United States has had in high technology exports is gradually eroding.

In addition, much of the R. & D. money available has been channeled into meeting the requirements of an increasing number of federal regulations. Not only does this inhibit innovations, but it also distracts from the development of technology break-throughs into marketable products. This is in sharp contrast to a countey like Japan where research efforts are concentrated in developing and improving competitive products. The follow-through after innovation is lacking the U.S. approach to R. & D.

Recommendations

(1) A tax climate conducive to the expansion of R. & D. efforts should be developed.

(2) Government involvement in research and development areas appropriate to government activity should be encouraged.

(3) Joint R. & D. efforts with other countries should be considered in areas where economies of scale would be beneficial and where a sharing of technology would be mutually advantageous.

(4) To the extent that antitrust laws permit, and perhaps there is need for revision of our antitrust laws here, there should be greater industry-industry cooperation in R. & D. directed at producing goods or services suited for export markets.

CONCLUSION

The declining strength of the United States in the international trade arena is a source of growing concern to the U.S. business community. Persistent trade deficits not only weaken the international position of the United States, but also impact adversely on its domestic economic well-being. One effective way of rectifying the trade problem is to expand exports.

Increased exports would contribute not only to a more favorable balance of trade for the United States, but would also result in a stronger dollar, a lower rate of inflation, lower consumer prices, and more jobs. In addidion, the profits from export expansion would increase funds available for capital formation, research and development, and increased productivity—all of which would contribute to a healthier U.S. economy.

The United States has not in the past been as dependent on foreign markets to absorb its productive capacity as have most of its trading partners. As a consequence minimal attention has been paid to the U.S. export potential, Now, however, the realities of international interdepencency demand that the United States pursue as a national objective a vigorous export expansion effort.

To reach this objective, existing governmental disincentives to exporting should be eliminated, unless concerns essential to national security dictate the contrary. These disincentives occur in the areas of ineffective government organization, detrimental consequences of regulations, limitations on trade with nonmarket economies, trade-restricting antiboycott regulations, a vague Foreign Corrupt Practices Act, slow export licensing procedures, and antitrust laws unnecessarily restrictive in foreign markets. In addition to clearing the way for exports domestically, foreign constraints to U.S. exports in the form of tariff and nontariff barriers must be lessened.

With these disincentives removed, the private sector must take advantage of a clearer path and seek out and develop foreign markets for its products. Businesses already involved in international trade should expand existing export activities, and the clearing away of disincentives should be an invitation for new firms to enter the export market.

If export expansion is truly a national priority, the government should play an active role in facilitating the way to increased exporting. It should encourage private industry by providing stimulative policies and programs in such areas as tax, financing, technical assistance in marketing, trade agreements, and research and development. Such incentives would go a long way toward convincing private enterprise that the governmentis committed to export expansion as a permanent feature of federal policy.

The United States has a vast export potential waiting to be tapped. By adopting the policies and programs recommended in this report, government and business can take that potential and turn the U.S. trade imbalance around.

INTERNATIONAL DIVISION ACTIVITIES

International economic policy section

The International Division staffs a system of committees, subcommittees and task forces whose business members develop positions on international trade, investment and economic development issues for the National Chamber. These positions are the basis for congressional testimony and policy and program recommendations to the administration. Issues of current concern include; export controls; multilateral trade negotiations; the Arab boycott; export financing; trade with socialist economies; trade in services; export promotion; codes of conduct; overseas business payments; transfer of technology; foreign investment in the United States; U.S. investment abroad; expropriation; tax treaties; foreign investment taxation; energy and resource needs; commodity agreements; Law of the Sea; foreign source income taxation; overseas voting rights; the human rights issue in international economic policy; and social security agreements.

The International Economic Policy section monitors and analyzes legislation affecting American business abroad, prepares testimony on the most significant bills before Congress and advises National Chamber members on crucial legislative developments. Close contacts are maintained with key congressional staff and executive branch officials on matters affecting international business.

In addition, the Section offers practical guidance and assistance to member firms, local chambers of commerce and other organizations in their efforts to expand international trade and investment and works to improve and expand national export promotion programs. It also works for more effective import adjustment mechanisms and promotes two-way investment.

International economic affairs section

The International Division develops and conducts the foreign relations of the national Chamber. Through a process of business diplomacy involving business leaders in the United States and overseas, the Division develops recommendations on international economic problems to assure that government policy-makers in the United States and foreign countries are well advised of business attitudes. Also, it is responsible for the National Chamber's important working relationships with AmChams and for maintaining close contacts with foreign counterpart business organizations and foreign agencies involved in international economic matters.

The International Economic Affairs Section's activities are divided into six regional areas:

African Affairs: Efforts are being made to facilitate American business relations with all countries of Africa. This program includes efforts to establish American chambers of commerce in key countries. AmCham Morocco has been operating since 1966, and AmCham South Africa was inaugurated in November 1977. In addition, practical workshops and other initiatives for business development throughout the continent are emphasized.

Asian-Pacific Affairs: In addition to providing liaison for the 12 AmChams comprising the Asia-Pacific Council of American Chambers of Commerce (APCAC), the National Chamber provides the secretariat for the Advisory Council on Japan-U.S. Economic Relations. The Council is composed of chief executive offices of 50 major U.S. corporations who meet annually with their Japanese counterparts. The two groups also cosponsor a series of "quadrilateral" businessmen's conferences with representatives from Europe and the Middle East to address the wide range of trade, investment, monetary and natural resource issues facing both developed and developing countries. The National Chamber also staffs the India-U.S. Business Council, involving U.S. business leaders and their Indian counterparts in discussions on economic and commercial policies designed to strengthen the bilateral relationship, promote expanded trade and encourage U.S. investment in the Indian economy. A council linking the business communities of the United States and the five member nations of the Association of Southeast Asian Nations (ASEAN)—the Philippines, Indonesia, Singapore, Malaysia and Thailand—will begin operating in 1979.

East-West Trade: The National Chamber provides staff support for U.S.-Eastern European economic councils with Romania, Hungary, Poland, Czechoslovakia and Bulgaria. These councils serve as recognized channels for communication between key U.S. business leaders and their East European counterparts. In an effort to expand trade and industrial cooperation, the councils closely examine legal and economic bottlenecks that hinder commercial interchange between the U.S. and selected Eastern European nonmarket economies. The National Chamber also holds a permanent seat on the board of directors of the U.S.-U.S.S.R. Trade and Economic Council—a business organization formed to facilitate U.S.-Soviet trade, and has a cooperative agreement with the U.S.S.R. Chamber of Commerce to encourage commercial relations.

European Affairs: The National Chamber maintains close liaison with 12 AmChams in the Western European and Mediterranean area and with their regional council, the Council of American Chambers of Commerce—Europe and Mediterranean (EuroMed)—communicating relevant trade and investment news to this region and tracking those aspects of Europe's political and economic evolution, inside the European Community (E.C.) and out, which may be significant for American business. The National Chamber staffs the E.C.-U.S. Businessmen's Council—a body of top American and Western European business leaders who deal on a continual basis with economic issues affecting the Atlantic Community and who advise their respective governments on how to deal with them. In addition, annual, formal conferences between private sector agricultural leaders from the European Community and the United States are organized by the National Chamber.

Hemispheric Affairs; The National Chamber staffs three important institutions which reflect the special geographic and historical ties between the Unitod States and other Western Hemisphere nations. The are: the Association of American Chambers of Commerce in Latin America (AACCLA), representing over 17,000 corporate and individual AmCham members in 15 Latin American countries, which was founded in 1967; the Canada-U.S. Committee, jointly sponsored with the Canadian Chamber of Commerce, which has met biannually since 1933; and the Brazil-U.S. Business Council, established in 1976 as a channel of communication between business leaders of the two countries. AACCLA, the Canada-U.S. Committee and the Brazil-U.S. Business Council formulate recommendations on economic relations between these countries and the United States.

Middle East Affairs: Reflecting the rapidly growing importance of the countries of the Middle East to U.S. economic interests, and as part of the National Chamber's effort to address the energy and natural resource problems facing the business community and the trade, investment and monetary implications of these problems, the National Chamber staffs various activities involving the Middle East. In addition to monitoring developments in the area relevant to American business and advising members of emerging trade and investment opportunities in the region, the National Chamber administers four bilateral business councils with Egypt, Israel, Iran and the Sudan. These councils involve prominent American business leaders with their counterparts in discussions of trade and economic policy issues to improve bilateral commercial relations and to expand mutually beneficial flows of trade and investment.

International research and special projects section

The International Research and Special Projects Section is responsible for the study, analysis and preparation of research reports and issue papers that are used for policy develoment and implementation by the Division's International Economic Policy and International Economic Affairs Sections. In addition, this Section monitors legislative developments and activities of intergovernmental organizations that have an international economic impact on the U.S. business community.

A variety of reports, surveys and other publications are produced by this Section to educate and mobilize the public on important international commercial and economic questions, including the monthly *International Report* and the *Trade Negotiation Information Service*, which is published on an *ad hoc* basis in the form of updated bulletins and special reports on continuing multilateral trade negotiations.

This Section organizes conferences, seminars and symposia to publicize topical trade and investment issues and to help frame solutions to related international economic questions. Also, it privides sources of information for certain business and cultural inquiries on the international level, including importing and exporting, employment overseas and technical associations.

STATEMENT OF RICHARD C. FENTON, PRESIDENT, FENTON INTERNATIONAL INC.

In announcing this hearing, Subcommittee Chairman Harry F. Byrd Jr. said: "The time has come to get serious about an Export policy * * * In the light of the costs of energy imports, we cannot afford not to have a program to increase Exports. And we should be especially interested in encouraging medium size and small companies to export."

I have been involved in U.S. exports, and in doing business for U.S. companies around the world since the early 1950's. First I helped one company make a serious start in International business as an executive, and in 16 years the business abroad grew from almost zero to about $350 million of annual sales with good profits and a very favorable balance of payments for the United States. For the last 12 years I

have been helping other mostly smaller and medium size U.S. companies as a consultant try to achieve similar results.

During the second half of the 1960's and early 1970's I was a member of the Secretary of Commerce's National Export Expansion Council and of the Colorado Regional Export Expansion Council, as well as of other industry advisory groups concerned with exports and International business.

Recently, in order to try to fill what some business friends and I saw as a need, we have started the Committee for Small Business Exports (CoSBE) of which I am President. This is the organization that I represent today. We have only just started, and so far we have 15 dues paying members in nine States. We hope to have more than 100 dues paying members by the end of this year, and eventually more than 1,000. By our Articles and Bylaws all our members must have total sales including exports of less than $100 million. Our members are and will only be smaller and medium size companies.

The basic objective of the Committee for Small Business Exports (CoSBE) is to persuade the Congress and the Executive Branch of the Government, as well as related organizations such as the Eximbank and the FCIA to pay more attention to the needs of smaller and medium size companies which are involved or which could be involved in exports. In addition, we will help our members to solve common problems in their dealings with the Government. We are not against the large multinational Corporations. We share many interests with them.

But some of our interests and needs are not important to them. Se we decided that we must have our own Committee to stress our particular point of view. In addition, we believe that it will be useful for the Congress and the Executive Branch to have an organization consisting only of smaller and medium size companies involved in exports to which they can turn for advice and assistance.

I have believed for a long time and at least since 1963 that smaller and medium size companies must be provided with incentives to export and to engage in International business, if the United States is ever to solve its balance of payments problem, and if the Dollar is ever to become a strong currency again. Smaller and medium size companies cannot in the short term make a major contribution. This must come from the large multinational corporations which are the largest exporters and the source of repatriated foreign income, and also have the largest amount of production abroad. However, my personal experience is that smaller companies can become large corporations. A company exporting $1 million in 1979 can be exporting $50 or $100 million in 1989. However, the carrot of future large profits and cash flow must itself be sufficiently enticing to overcome the present high costs and initial problems.

Therefore, our first recommendation must be that smaller and medium size companies, both those now exporting and those which could export, be provided with substantial incentives specifically designed to encourage them to export more.

I have heard many proposals over the years for suitable incentives, and I have not so far heard any which in my opinion would be as effective as tax incentives—provided the latter are substantial enough. Before 1963 and Subpart F the United States had a tax incentive for exporters since a U.S. corporation was permitted to defer export profit if earned through a foreign corporation. Many of our principal foreign competitors still have situations like this. After much debate within the Administration and the Congress, the pre-1963 situation was partially restored through the DISC legislation. Because of the strict pricing rules and the "deemed distribution," even before the incremental rules were established in 1976, only about one quarter of the tax on export profits was effectively deferred through a DISC. This is a modest incentive indeed, and it has been made more modest by the 1976 changes. However, the DISC exists, and it has proved to be an effective incentive for many smaller and medium size companies. I have had contact with several hundred such companies with DISC's, and almost unanimously they strongly believe that their DISC's have stimulated and helped them to increase export sales substantially. They firmly believe that the DISC law has been effective in its purposes, and should be improved and made more effective. They are convinced their DISC's have been cost effective to the United States in that their DISC's have generated additional exports which would not have taken place without them, and these additional exports have produced more tax revenue to the U.S. Treasury than the tax deferred in the DISC's. Our membership agrees with all these positions. Therefore, our second recommendation must be that unless and until some better incentive can be devised and put in place, the DISC should be retained and improved, regardless of the wishes of our foreign competitors. It is in the interest of foreign countries almost as much as in our own that the United States should solve its balance of payments problem.

The DISC as it stands is a rather modest incentive for smaller and medium size companies. The costs of entering export markets in a sophisticated way are high. The payoff can be a long time coming. An incentive must be correspondingly substantial to be effective. At least for smaller and medium size companies we need DISC to be more like its original proponents had in mind. Therefore, we recommend two changes designed to improve the incentive for such companies. First, the "deemed distribution" of 50 percent of DISC income should be eliminated to permit 100 percent instead of 50 percent tax deferral on at least the first $1 million of DISC income. Actually, because of the pricing rules, 100 percent deferral would not take place—it would be nearer 50 percent of total export profit after this change. Second, the small DISC exemption to the incremental rule should be increased to $1 million. I am not sure in either case that $1 million is high enough, but it should help. It may be objected that the cost of these changes to the Treasury is too high. We would urge that the additional exports which would result from the changes would produce more tax than the additional tax deferred.

There are some practical problems with DISC which need to be addressed. First the law and regulations have become very complicated. Large corporations have large financial and legal staffs and the financial ability to pay for outside advice. Smaller companies may have one experienced financial man on the payroll and probably no lawyer. They do not have the profit and cash flow to spend on much outside help. If the Chief Executive himself cannot make time to understand the subject probably nothing will be done. The next recommendation is, therefore, that the regulations and documentation requirements be simplified and streamlined at least for smaller and medium size companies.

There are some fairly simple ways to form and operate a DISC. But they are not known to most Chief Executives of smaller companies. No publicity appears to be given to them by the Government. An incentive is not likely to be effective if it is not known and understood by the companies for which it is intended. We recommend that the Congress persuade the appropriate Executive departments to give intensive and effective publicity to these more simple ways of forming and operating a DISC, as well as to the simplifications which will hopefully now occur.

One of the major problems with DISC is that at least since 1975—only 4 years after enactment—it has been the subject of intense controversy in both Congress and Executive. Many smaller and medium size companies have been unsure whether to use a DISC. They did not understand what their Government's policy was—and still do not. On the one hand they are urged to export more, and on the other the only practical incentive available to them is threatened with extinction. What can be done about this we do not know—but it would certainly improve a National export policy if it could include an unequivocal statement that the DISC is part of it.

There is some talk about designing new incentives to replace DISC. We would certainly be willing to participate in the consideration of alternatives. However, our criterion for judging proposals will clearly be whether they are likely to be more effective incentives for smaller and medium size companies than what we now have—hopefully improved as recommended. At least we hope and urge that the experience and views of smaller and medium size companies will be sought and listened to in this process. Top executives of such companies are more likely to be able to give reliable advice as to whether any particular proposed incentive would be effective in its purpose than specialist financial or legal people or academics or bureaucrats. It cannot be too strongly emphasised that the primary purpose of an incentive is to persuade the Chief Executives of target companies to pay more attention to exports and International marketing. They will do this if they see clearly and without the help of specialist tax advisers, accountants, lawyers and economists that International business will be at least as profitable as domestic U.S. business, or at least sufficiently profitable to justify their greater personal attention, and time, and their decision to allocate more of their very limited financial and human resources to it.

Senator BENTSEN. Our next panel will consist of Mr. John Neshiem, on behalf of the Semiconductor Industry Association; Mr. Peter F. McCloskey, president, Electronic Industries Association; Harold J. Winch, on behalf of the National Machine Tool Builders' Association.

If you gentlemen would please come forward?

Gentlemen, I want to apologize. I am going to have to leave. Senator Danforth will chair this until Senator Byrd returns.

We are very pleased to have you.
Which of you gentlemen would care to proceed first?
All right, Mr. McCloskey.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONICS INDUSTRIES ASSOCIATION

Mr. McCLOSKEY. Thank you. I have a short prepared statement that I would like to have submitted for the record. I would like to devote my few minutes to amplifying some of the points that were made in the questions and answers earlier today.

Mr. Sunley's comment about the United States still being the leader in research and development may be somewhat self-deluding, as Mr. Shepherd pointed out in his testimony that the nondefense-related R. & D. and nonspace in the United States is approximately $21 to $22 billion versus $14 billion in Japan.

I think if we further factored out the R. & D. expenses of looking for alternate energy supplies, which are very, very necessary, but which are not productive in the sense of passthrough to productivity but rather would be an offset against balance of payments, if successful, and if we took off the percentage of R. & D. directed toward Government regulation—by that, I mean the R. & D. necessitated by environmental protection regulations, by OSHA, by the Consumer Protection Agency and by the various other Government regulations, which again may be very socially desirable but are not productive in terms of its passthrough to the economy, we are talking about a considerably smaller number and one that calls into question whether or not we are, indeed, leading the world in research and development.

I think, further, that the Japanese capability of focusing their R. & D. would be impossible in the United States because of our antitrust laws and because of our basic competitive philosophy anyway.

So we have a further inroad on that figure.

I would also like to comment on the concept of the tax expenditure that Mr. Sunley mentioned. It really is not the same, his saying that it is a billion dollar expenditure, as it might be made over in HEW or someplace else.

What we are talking about is making the dollars available to industry and providing the incentive for industry to invest its own dollars, and by doing that, we are getting a much more efficient utilization of the research and development dollars.

I do not believe there are enough Government planners to decide which products should be research, what areas of application. By putting the research and development close to the marketplace, we have a much better efficiency in the passthrough of the research and development dollars towards our ultimate goal to improve our overall productivity.

I also would like to take a few minutes to amplify the question that was last asked by Senator Bentsen on 861 regs. Not only are the 861 regs, as they currently exist, a disincentive; what they do is require the U.S. manufacturer to apportion, or allocate a portion of its research and development dollars against its worldwide sales. That reduces the amount that can be applied against the foreign tax credit, but it also makes it, in some cases where a company is

in an excess foreign tax credit position, where most of the larger companies that are successfully operating abroad are, a portion of their research and development will just be plain not deductible in the United States.

That being the case, we have provided an incentive structurally for management to decide to move R. & D. in the United States to R. & D. offshore, which I think is very self-defeating at this particular point in our history. It may have made sense in the Marshall plan days, but it does not make sense today.

A more general point, in answer to the questions, I think the economists generally believe that we are underinvested in research and development in the United States, that we are not achieving our full potential for productivity passthrough. We do know that those companies that invest heavily in R. & D. have a much better productivity passthrough—some 75 percent better in terms of their own employees productivity—than the productivity of nonintensive R. & D. firms.

Further, that the R. & D. that results in that productivity that I just mentioned is a factor in measuring the productivity of the company doing the R. & D. In most cases, the R. & D. productivity factor, if you will, is better measured by the sector served, because if the result of the R. & D. becomes capital equipment that is bought by some other sector of our economy, then you might expect the productivity improvements to be in the sector that utilizes the capital equipment in their own processes, which becomes basically the raw material for their own productive activity.

Further than that, economists have demonstrated clearly that productivity helps in holding prices down.

Those are all things we need to do today to improve our fight against inflation. We have got to hold prices down, and we have got to improve productivity.

Our last point is somewhat more subtle, but I think deserves to be made. I think it is up to the Congress and not the business community to structurally develop an environment that favors research and development. If you asked most business executives, if you asked all of then they would say the same thing. They would rather have unrestricted dollars to use any way they can use them.

But as we go from an economy that was largely entrepreneur, owner, to professional management, the emphasis is increasingly on the bottom line. The professional management is measured over a shorter period of time. They are not the principal stockholders in the company and cannot afford the luxury of the very, very long look.

As Mr. Shepherd said in his testimony, the pressure is on the bottom line today. I think it is up to the Congress to create the environment that puts structurally some emphasis on the future, because if we do not, we are selling our birthright.

In order to do that, the investment tax credit would be a very effective way of saying just that, that we, as a society, would want to favor R. & D. and to put an emphasis on R. & D. in the business sector.

So those are just some general comments. I would appreciate it if my prepared remarks would go into the record.

Thank you.

Senator BRADLEY. Thank you very much for your testimony. Mr. Nesheim?

STATEMENT OF JOHN NESHEIM, TREASURER, NATIONAL SEMICONDUCTOR CORP., SANTA CLARA, CALIF.

Mr. NESHEIM. My name is John Nesheim and I am treasurer of the National Semiconductor Corp. of Santa Clara, Calif., which has annual sales in excess of $600 million. For the past 13 years, I have been helping finance the growth of international business, particularly industrial high technology companies.

My experience spans years with Chase Manhattan Bank, with venture capital electronic companies, and with large multinational corporations. I earned an engineering degree from the University of Minnesota and an MBA from Cornell University where I majored in international finance.

I appear here today on behalf of the Semiconductor Industry Association, a trade association composed of 33 U.S. manufacturers of semiconductors.

I request my full written testimony be included in the record and I will now summarize that testimony.

Our association strongly supports the legislative proposals which are under consideration by this committee today. We believe that these four bills, S. 231, S. 700, S. 10003, and S. 1065 will help small business by permitting rapid recovery of capital investment and will stimulate and encourage research and development activities by businesses. Research and development is the lifeblood of high technology industries, and this is particularly true of semiconductors.

The legislation before the committee today will also facilitiate basic scientific research by colleges and universities because one of the bills, S. 1065, will provide tax incentives for grants by corporations for basic scientific research. Moreover, this bill will have the effect of increasing research opportunities for U.S. engineering and science students, thereby increasing the pool of talent available to high technology industries.

Also, the legislation before the committee will help to encourage exports by U.S. businesses. S. 1003 is particularly designed to have this effect. Substantial exports are highly important if the United States is to retain its advantage in semiconductors and other high technology industries and will also help the United States solve its critical balance-of-payments problem.

In my testimony today, I would like to explain briefly the threat which confronts the U.S. semiconductor industry in the form of unfair foreign competition which is often supported by foreign governments which place a high priority on export industries.

I would also like to discuss the critical role of capital formation in high technology industries, and explain the difference between capital formation in a free enterprise economy, such as that of the United States, as opposed to the situation in a planned national economy.

Then I would like to comment more specifically on the legislation before the committee today, and explain how this legislation will help our industry, and other similar industries.

It is fundamental to the American capital markets that profitable companies can grow faster through the use of borrowed moneys. In a free market system, borrowings, together with interest, must be repaid from the earnings of the borrower. Further, in a free market system, borrowings must have a foundation of equity or risk capital.

The larger the proportion of debt to equity there is, the smaller the amount of equity, the greater is the risk of default—that is inability to repay the debt from the earnings of the company or from the equity base. For a given amount of equity, the more debt one has, the more capital—debt plus equity—can be raised. The ratio of debt to equity is called leverage.

The benefits of leverage can be great. For example, large amounts of debt can compensate for inefficiently run—or noncompetitive—companies. The return to shareholders can be boosted sharply and quickly by an injection of debt. High returns on shareholder's equity can be earned by three different means:

High efficiency and excellent manufacturing that produces a high level of earnings;

Aggressive marketing which generates a large amount of sales for each dollar invested in the company; or

Extremely high proportions of debt per dollar of equity which can protect a less efficient company.

U.S. companies currently have about double the return on equity of Japanese competitors. Such levels of earnings are necessary to finance new R. & D., to pay for the latest sophisticated equipment, and to provide for increased capacity to manfuacture new products.

Exhibit 1 shows that the earnings of U.S. manufacturers are three times as much per dollar of sales as their Japanese counterparts. That level of earnings is necessary in a free market economy to attract fresh capital to this industry which has rapid advances in its technology and must continually develop and market products which incorporate newer, better ideas.

U.S. companies have 60 percent to 100 percent more sales per dollar of capital than the Japanese companies. This indicates a very effective and efficient use of assets by the U.S. companies—a higher level of technological efficiency.

Command of complex manufacturing processes is the key here. Should the United States lead in technology falter, there would be a domino effect, causing return on equity to fall and subsequently causing a sharp reduction in the amount of capital which would be attracted to the industry. Then growth would slow, including noticeable reductions in both exports and employment.

In light of the present record of excellent performance, one might ask why U.S. companies are concerned? Good management plus control of technology make a winning combination. Well, that sounds fine, but in addition to people and equipment, there is a critical third ingredient: cash. In more formal terms, capital formation.

The Japanese understand this well. In fact, they may play catchup by borrowing 2, 20, even 40, or more times as much debt per dollar of equity as would be available in the free capital markets. This aspect of their planned economy gives them a distinctive competitive edge.

If there is any doubt that the Japanese economy is planned, let me read you a quotation of Hiroshi Kawasaki, of the International Trade Policy Bureau of MITI: "American business must realize and accept that Japan is not really a free economy. It is a highly planned economy."

So why do U.S. companies not counter such a competitive move by borrowing equally large amounts? After all, as exhibit 1 shows, using Japanese proportions of debt would more than double the return on equity for U.S. company.

The answer is our free market economy. In general, the U.S. companies raise cash in the open, competitive markets in the United States. Capital formation, the key to growth, depends in our country on our free capital markets which allocate investment funds among competing applicants.

American bankers make loans to companies that are on their own to live or die in the free marketplace, openly competing against any challenges.

Some win and grow profitably. Others lose and go bankrupt. Once bankrupt, U.S. companies cannot expect the U.S. Government to bail them out by instructing banks not to foreclose on loans.

In the Japanese system, that is not so. Large companies that get into financial difficulty have an assured source of substantial financial help from the Japanese Government. Moreover, business recessions in the protected Japanese home market are virtually nonexistent compared with those in America.

America to a large extent absorbs Japanese unemployment.

That is why American bankers will lend only a fraction of the debt to U.S. semiconductor companies that Japanese bankers supply to Japanese companies. In fact, if you ask U.S. bankers with branches in Japan how they can justify lending as much debt to Japanese companies which have a very thin equity base, they all eventually get around to the concession that the risk in such loans is not a risk in an individual company, rather it is a loan whose risk is a country risk: Japan. Such actual or implied governmental guarantees make a substantial difference.

There is a further concern that U.S. high technology companies have: lower margins on sales. For example, a foreign company can try to buy a share of the market by reducing prices sharply. Undercutting U.S. prices in the large, fast-growing U.S. market for semiconductors is such an example.

Such a threat seriously jeopardizes capital formation processes in the United States. For instance, if American companies have to meet Japanese prices and thus cut earning margins to Japanese levels, then the return to shareholders will be cut by half, three-quarters or more and perhaps eliminated, as shown in exhibit 1.

Nippon Electric Co., a large Japanese semiconductor producer, announced profits for fiscal year 1979 which constitute a return of 1.2 percent on sales. American companies could not survive for long with such a low return.

Lower earnings from reduced prices, however, are not a problem for the Japanese companies, however, as they have a pipeline to the banks and do not raise capital in competitive markets.

If foreign competitors are allowed to engage in economically unrealistic price-cutting tactics, as happened in the television industry, it could be catastrophic for the U.S. semiconductor industry: No more new capital, slower growth, less earnings, lower motivation for employees, and another U.S. high technology industry bites the dust.

The Japanese semiconductor spokesmen have expressed concern about the worldwide tendency toward protectionism. This generalization simply fails to distinguish between an action and a reaction by the domestic industries in markets invaded by the Japanese. What they are seeing is a reaction to their grossly unfair international trade practices.

In contrast, they have acted initially in the most fundamental protectionist manner by a series of formal and informal trade barriers unprecedented for a developed economy of the 1970's.

I wholeheartedly agree with Senator Bentsen, who summarized the issue so eloquently in a speech on the floor of the Senate on May 3, 1979:

> Trade between nations is becoming an increasingly carnivorous activity, and the traditional free trader has all the advantages of an antelope in a world of lions.
>
> We can no longer tolerate situations in which foreign competitors utilize unfair trade practices to rout and destroy a domestic industry, such as television, and remain immune from punishment until they have achieved their objective.

I would now like to comment in detail on the legislation which is before this committee today, and explain how enactment of these proposals will help alleviate some of the problems I have just outlined.

S. 231 would aid capital formation by increasing the asset depreciation range variance from 20 percent to 30 percent and by providing a simplified straight line depreciation table for small businesses which have an adjusted tax basis in assets of $250,000 or less.

This legislation is not specificlaly aimed at the problems of high technology indutries, but would certainly help high technology businesses, as well as other industries, by allowing a faster recapture of investments made in plant and equipment. One of the problems for the semiconductor industry is that the technology changes so rapidly that some plant and equipment quickly becomes obsolete.

Therefore, our industry believes that an increase in the ADR variance would not only be helpful, but would also be more realistic in terms of needs of our industry for rapid replacement of equipment becaue of technological innovation.

Also, the proposal for a simplified depreciation table would probably not help established businesses, due to the $250,000 limitation. But the proposal might be of some benefit to new venture-capital businesses getting started in high technology industries.

We note particularly that the proposal to allow a 2-year useful life for information systems, computers, and other data handling equipment would be of great benefit to new enterprises in high technology industries.

We believe that this legislation will help to stimulate small business. In a high technology field, such as ours, proposals which stimulate small business also benefit larger more established com-

panies, because much of the pioneer technological research and ideas come from new business ventures.

S. 700 would permit the 10-percent investment credit to be available for research and development expenditures. This legislation would be of substantial assistance to the semiconductor industry and similar industries which are engaged in a constant technological struggle with foreign competitors, many of whose governments provide substantial direct and indirect assistance for technological innovation.

As Senator Danforth said in introducing this legislation:

> It is widely recognized that one of the contributing factors of our declining foreign trade position is the erosion of the technological advantage that U.S. industry has historically enjoyed vis-a-vis the rest of the world. A related problem is the marked slowdown in the growth rate of U.S. productivity—economic output per unit of labor force input.
>
> I am convinced that both of these economic problems are, to a significant degree, directly related to the sluggishness of this country's commitment to research and development investment and the simultaneous upswing in R. & D. investment by our major trading partners.

This statement, in our view, concisely and accurately summarizes one of the major problems faced today by U.S. industry in general and by high technology industry in particular.

We further submit that the purpose of the legislation, to allow the investment credit for research and development expenditures, is consistent with the basic purpose of allowing an investment tax credit for machinery and equipment. The investment tax credit, as embodied in the law tody, serves a number of purposes. It creates jobs by stimulating investment. It increases productivity by making available to businesses a source of capital to modernize their plants.

Finally, the investment tax credit is one means of helping U.S businesses remain competitive with foreign companies, many of whom receive substantial investment assistance from their own governments.

An investment tax credit for research and development expenditures would stimulate jobs directly and indirectly. Direct stimulation would occur through increased expenditures by U.S. businesses for research and development. Indirect stimulation would occur from the technological breakthroughs resulting from the research and development.

New products, new technological innovations and, indeed, whole new industries might well be created as a result of increased research. Conversely, if the United States falls behind foreign competitors in technological innovation, many U.S. jobs will be lost to foreign imports.

In the same regard, providing an investment tax credit for R. & D. expenditures will help to make available to U.S. businesses some of the capital which will enable the businesses to modernize and maintain our all-important technology lead.

For all of these reasons, we strongly support S. 700.

S. 1003 is designed to stimulate the export of U.S. products by making three changes or clarifications in the tax law.

First, a firm would be permitted to deduct, as a reserve for foreign bad debt losses, an amount equal to 15 percent of its

taxable export income or 2 percent of the outstanding export credits appearing on its balance sheet at the end of the year.

However, the total reserve under this provision may not exceed 5 percent of the company's outstanding export credits.

Second, the legislation would encourage exports by clarifying that amounts expended by a company for foreign market studies, foreign marketing expenses, including amounts paid to modify U.S. products to qualify them to meet foreign market requirements, as well as the cost of applying for and maintaining international and foreign patents, would all qualify as research and development expenditures, eligible for the election provided by Congress under section 174 of the Internal Revenue Code.

This provision would be especially helpful in the face of objections, asserted by the Japanese, that U.S. industry does not succeed in Japanese markets because the U.S. business does not "understand" the Japanese market, or because there are "quality differences" in the Japanese and U.S. products. We note that the Japanese are usually reluctant to be specific about these quality differences.

Finally, the legislation would reduce problems of entering the export market based on concerns about currency fluctuation losses on export credits which had not been repaid by the end of the year.

We strongly support all of these proposals, which are designed to encourage U.S. exports. In our view, it is vital to the U.S. interest, and to the interest of U.S. industry, to become more competitive in international markets, especially in high technology industries.

S. 1065 would provide a Federal tax credit of 25 percent of grants made by corporations to colleges and universities for basic research. The credit would be incremental in the sense that it would be available only to the extent that basic research grants for the year exceeded average research grants made during a 4-year moving base period.

This proposal will help to stimulate research in the basic sciencies by encouraging corporate grants for scientific research. Therefore, we believe the proposal will further U.S. technological innovation by helping to create a base of fundamental research which business and industry can build upon in the field of applied science.

Moreover, grants of this nature will increase the pool of talented highly skilled engineering students who will later become innovative leaders of U.S. businesses.

However, we note that, under the proposal, scientific basic research means research the results of which are made freely available to the general public. This presumably means that the results of the research would be available to foreign competitors, as well as to U.S. businesses.

Also, the incremental feature of the bill could result in problems. Under present law, corporations are generally permitted to make tax deductible contributions to charity in an amount equal to only 5 percent of the corporation's taxable income. As a practical matter, unless a corporation making grants for basic scientific research had continually rising income, eventually it would bump against the 5-percent ceiling.

When this happens, under the bill, the corporation could receive a tax credit for contributions in excess of the 5-percent ceiling, but would not be entitled to a tax deduction.

However, if the corporate grants did not exceed the 5-percent deduction limitation, no credit would be available under the bill because the corporation's basic research grants would not exceed the level of grants during its 4-year base period.

There are several possible ways to improve this situation. One possibility would be to remove the incremental requirement from the bill. Another possibility would be to amend section 170[b][2] of the Internal Revenue Code, to provide that amounts eligible for the basic research tax credit under this legislation would also be eligible for an income tax deduction without regard to the 5-percent limitation which normally applies to corporate charitable contributions.

The legislaton which is before this committee will be of benefit to the U.S. semiconductor industry and to other high technology U.S. businesses. The legislation will help to stimulate capital formation for research and development and will also encourage U.S. penetration of export markets.

At the same time, it must be remembered that no amount of stimulus to capital formation can totally offset the tremendous amounts of capital which a planned national economy can make available to a preferred export-oriented industry.

We strongly support the four bills under consideration by this committee today and believe that they should be enacted. However, for our industry, this legislation, helpful as it is, is far from a complete solution to the problems which we face from unfair foreign competition.

This problem can only be met through strengthening and vigorous enforcement of the U.S. laws which require fair competition in international trade and which outlaw such practices as two-tier pricing. We are aware of the efforts of this committee to try and insure that the U.S. trade laws are adequately enforced. We would like to express our gratitude for these efforts as well as for the efforts in sponsoring the legislation before this committee today.

Senator BRADLEY. Thank you very much.

Mr. Winch?

STATEMENT OF HAROLD J. WINCH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MINSTER MACHINE CO.

Mr. WINCH. Good morning. My name is Harold J. Winch. I am president and chief executive officer of the Minster Machine Co. We are located in Minster, Ohio and employ approximately 900 workers.

I am representing the National Machine Tool Builders' Association, a national trade association whose over 370 member companies account for 90 percent of the U.S. machine tool production. The U.S. machine tool industry currently employs approximately 97,000 workers.

We welcome this opportunity to assist this subcommittee in its reassessment of the current U.S. capital cost recovery system.

Before specifically addressing the depreciation reform bills currently before this subcommittee, we would first like to briefly comment on the very substantial effect that capital cost recovery

and depreciation tax policies have upon productivity and inflation in America.

The ultimate result of inflation is increasing prices. And, in manufacturing, or any business for that matter, prices have three major elements: The cost of purchased components; the cost of labor; and the cost of all other nonlabor payments.

Nonlabor payments are the sum of profits plus such nonlabor costs as interest, depreciation, rents and royalties, taxes, regulatory and inspection fees, et cetera.

Chart 1 shows, rather dramatically, that every element in the nonlabor payments of American businesses has increased substantially, with the single exception of profits.

The second element is the cost of labor. Unit labor costs are what we pay our workers, divided by the real value of their output.

The final element, the cost of purchased components, is a passthrough item that has little effect upon the ultimate price of a nation's manufacturing output. As a result, it is the total labor and nonlabor costs and payments, by everyone in the stream of commerce, that finally determines the price of goods.

Therefore, when we look at the costs that affect prices for all manufacturing, we need to study just two factors: unit labor costs; and unit nonlabor costs.

Our full statement sets forth an analysis of how these two factors interacted in the U.S. economy during the years 1955 to the present. Succinctly, the conclusion of this analysis is that if reasonable wage increases are balanced with adequate productivity gains, the result is constant unit labor costs. And if unit labor costs are constant, then everyone gains because prices are stable, profits rise for business, tax income rises for government and real spendable income rises for workers.

All of these things happened in the early 1960's. Unfortunately, in the mid-1960's, the economy lost this former stability and has yet to regain it.

Wage increases are not, necessarily, the inflationary culprit, because with rapidly rising productivity it is possible to offset increasing wage rates, thus dampening—or even eliminating—unit labor cost increases.

In other words, one way to bring prices under control—either as a nation, as an industry or as an individual company—is to increase productivity faster than total wages. And as chart 3 shows, for more than 25 years our national growth in productivity has traveled hand in hand with investment.

Thus, the depreciation reform bills before you today must be viewed not as tax incentives nor as tax expenditures but as weapons in the war on inflation. They should be enacted immediately.

In 1978, NMTBA conducted a study of 16 major metalworking companies' annual reports.

The results of this study were presented to the Finance Committee in testimony given last year and were referred to by Senator Chafee in the introductory remarks to his bill, S. 935, entitled the "Capital Cost Recovery Act of 1979."

In summary, those results reflected a capital spending history that exhibited the beneficial effect of the confidence and stability of the early 1960's. Then capital expenditures stopped rising and hit a plateau that lasted 7 years. In 1973, capital spending took off again, but gains were almost completey wiped out by inflation.

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Actually, real capital spending has been declining steadily since 1965.

Is it any wonder that much of American industry is being eaten alive by more productive foreign competition—particularly from Japan?

Since 1970, America's metalworking industry has been in unconscious and involuntary liquidation. And the same probably holds true for almost all of America's manufacturing industries. It is time that we clear the air and stop this liquidation so that we can modernize and grow.

Either of the depreciation reform bills recently introduced by Senator Chafee and Bentsen if enacted into law would be major steps toward providing the type of atmosphere necessary for the revitalization of American industry. We commend both Senators for their insight on this issue.

While the provisions of the two bills differ somewhat, their underlying message is the same: America must do what is necessary to increase internal capital formation to permit industry to more quickly recover its capital investment.

Senator Bentsen is to be commended for his ADR reforms. The NMTBA has long advoacted increasing the current 20 percent ADR to at least 30 percent as one means of raising the amount of funds business can internally generate for capital spending.

We respectfully suggest that the possibility of extending the ADR even further to 40 percent be considered, so as to make possible greater investment in more productive equipment, thus curbing inflation.

Senator Chafee's 5-year amortization proposal is also to be commended for its encouragement of inflation fighting capital investment. However, we would recommend two modifications of S. 935 which would make it an even more effective spur to greater productivity and lower inflation.

First, we would strongly urge that the full 10 percent investment tax credit, now available only when assets are depreciated over 7 or more years, be made available to companies even when they opt for the shorter 5-year depreciation period.

Second, we would strongly recommend that the pollution equipment amortization provision both be shortened to a 1-year writeoff period and broadened to include all Government-mandated equipment, including OSHA required safety equipment.

In conclusion, improving the cash flow of industry through the changes provided in these bills has never been more important than it is in today's inflationary times. As demonstrated by our example of the 16 metalworking firms, current capital spending recovery mechanisms are inadequately dealing with the rising prices of new productive machinery. Every year that recovery of a portion of the original capital outlay is postponed translates into a further shortfall between the cash flow generated by depreciation and the actual outlay needed to replace the depreciated equipment.

The key feature of any of these changes in depreciation allowances is that they would attempt to treat capital spending more rationally as a cost of doing business rather than simply as a tax allowance for the wear and tear on equipment which is now the effective case.

A depreciation policy that allows business to more fully recoup the replacement cost of aging capital equipment over a shorter timespan also means that a firm's operating profits would not have to be utilized to replace obsolescent machinery.

The current practice of inadequate depreciation allowances artificially inflates profits at the bottom line of a firm's income statement. The changes we recommend would simply move the source of funds used for capital spending out of the retained earnings ledger back into the depreciation expense accounts where they more accurately belong.

The tax applicable to the firm's reduced earnings would then be a true tax on profits, not an unwitting tax on improperly amortized capital assets.

The tax changes Senators Bentsen and Chafee propose will promote the investment needed to boost lagging productivity, create new jobs, reduce inflation and generate the level of economic activity which will promote the balancing of the Federal budget.

A tax policy which recognizes capital accumulation as the cornerstone of our industrial society is needed to prevent the economy from falling into a pattern of unacceptably slow or negative growth. These changes would also reestablish the United States as the world's leader in technology and economic strength.

Thank you for the opportunity to testify before this subcommittee. We would be happy to answer any further questions at this time.

Senator BYRD. Thank you.

Senator Danforth?

Senator DANFORTH. I have one brief comment, Mr. Chairman. I very much appreciate the testimony of these witnesses. There is no reason on Earth why our country has to settle for chronic stagflation, and that is what we have had.

There is a debate now whether or not we are in a recession. Well, the definition of recession relates to a limited period of downturn of economic indicators.

The problem we have in our economy is much more long term than any temporary dip. For a number of years now we have been on a course where we have had a stagnant situation with no real hope for future growth in our economy.

I really think that the big issue is between those who believe in growth and those who do not. Those who believe we should start taking the steps necessary to permit our economy to expand and provide opportunities for our people and those who take what I consider to be a very short-term view, whose only concern is about the immediate revenue loss of any particular effort that we might try.

That is the basic issue. Within the population of those who believe in growth, if you asked 100 different people, you will hear 100 diffenent ideas on what we should be doing. There are some people who believe in rate reductions. There are some people who believe in investment credits. There are some people who believe in ADR, some people who believe in incentives for research and development.

We could argue those points forever.

Right now, I think that the key issues are depreciation in general, although there are several different proposals about what to do about depreciation, and what we can do to increase the commitment that we are making in America to new technology and to research and development.

I think those are the most likely issues and what I would hope is that those who are studying these issues could be as broad as you who have testified have been.

We can quibble—and we will—about the details, but I think it is important not to let the details camouflage the main objective. The main objective is to provide some positive incentives which, while they will involve at least a short-term reduction in tax revenues, will provide the kind of environment that is necessary for businesses to grow, for them to modernize their plant and equipment, for them to put more resources into R. & D., which investments by their very nature will not pay out in the next 1 year, or 2 years, or 3, but will pay out a decade or so down the road.

I think that is what we are talking about.

Thank you all very much for your comments.

Senator BYRD. Thank you, Senator Danforth.

Senator Bradley?

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

The other day, I received in the mail a questionnaire on which I was asked to choose which of the futures that were offered that I thought would best make the American economy competitive in the international markets, and one of them was a more centralized government control of the economy.

The second was a firmer partnership between government and the private sector, and it alluded to Japan.

The third was a continuation of the present circumstance where government and the private sector are in an antagonistic regulatory position.

And it seems to me that we must move more toward a greater cooperation and interdependence, and one of the things that concerns me—and Mr. Nesheim alluded to it, as well as Mr. McCloskey—that in the world market, we are competing with a country like Japan which goes into a market area with perhaps a kind of financing available to it that is not available to our private sector firms, and decides that its goal is not a short-term profit, that looks at the end of the year, but rather market share, and proceeds not just to implant itself in that market slowly and gradually, but brings along the management capability in the country at the same time.

What I would like to ask each of you gentlemen is do you think that this is primarily a problem of the Government creating the structure for long-term thinking, or do you feel that there are certain management decisions that have to be taken to encourage people to move into those areas of the world that are most open for our development; for example, in Southeast Asia or other parts of Asia, where it is not easy to put a management team in there and keep it there without the profit pressure of every year's balance sheet?

I would like you to talk a little bit about what management innovations might help in this area, as well as your belief that the

Government should set the long-term structural climate for that kind of thinking.

Mr. McCloskey. I think initially the major thing that could help is a firm feeling that we indeed have a national export policy. We still must apply for licenses to export, even to our most friendly nations, and there is a basic concept that it is a privilege, and certainly no realization that it is a necessity that we export.

The problem is that we have a huge U.S. economy that a large number of countries do not see the need to export, because of the hassle involved in exporting.

The second problem we have relates to our own antitrust laws with relation to what we can do abroad. For instance, there are a number of companies, large companies, that have management structures abroad and marketing organizations abroad but because of antitrust laws, they cannot market the products of competing companies who cannot make that investment.

I think we can do something about a trading company act, if you will, that would allow and facilitate the creation of marketing and management teams that can operate in a country over a long period of time and have some immunity from the antitrust laws as they relate to their activities.

We are finding that our hands are tied and our competitors are not structurally. That means that we are going to lose in the long run.

Mr. Nesheim. The industry starts in R. & D. If you do not start there, you are dead.

It is nice to be able to run a race and be promised a refreshing drink 2 miles down the road, but if you do not incentivize somebody to start, there will not be a race.

Structure is very important. You are absolutely right. You give me $10 in R. & D. dollars today and within 5 years I will give you $100 of sales, $30 of which will be overseas, and those $30 of sales will continue for 5 or 10 years more without more R. & D.

Second, be aware of whom you are competing with. The economic development boards of Ireland and Scotland were in my office last week. They are giving tax holidays. They are giving incentives. They are giving trading reductions. They are giving cheap loans. You name it, we got it, if we go overseas.

As far as access, we want access to compete. We are competitors; we want to stay healthy. Get us in those markets.

We are not talking about protectionism. We want to nail those guys in our home market, yet 10 percent of the market in the rest of the world, you have 60 percent. Something is wrong.

As far as action, remember that speed is everything in this industry. We obsolete things in 3 years.

It really frustrates that the Treasury Department sits there with $400 million of fines on their hands and yet are complaining about taking cash away from them. That is ludicrous.

We want to feel that the administration is acting on our behalf. We do not have acclusion and a great organization, just an attitude you Senators have, we think is tremendous. We would like that felt. We want people bargaining for us.

Get us into those markets and competition will take care of the rest.

Mr. WINCH. I believe the Congress has an opportunity to do something about export licensing as it considers S. 747, unanimously reported out by the Banking Committee. I cannot help but reflect, as I listened to the testimony this morning, about export licensing. I have to say to myself, "Export to whom?" The exercise in getting the product out of the country, in the event that you are able to sell it to begin with, is one of the most frustrating experiences you have ever had.

Many times it takes 18 months to get your product out of the country. Over 50 percent of the machine tools sold outside of the United States are sold to the Communist countries. The American Machine Tool Industry enjoys only 1 percent of that market.

If you want to balance payments, there is a good shot at it.

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

Senator BYRD. Thank you, Senator Bradley.

The Senator from New Jersey mentioned the questionnaire that he received, and one aspect of it spoke of the antagonistic attitude between government and business because of the vast amount of regulations. It seems to me that government is being very foolish to strangle business with regulations, for one simple reason: Government is a 50-50 partner with business—even better than a 50-50 partner, because government gets one-half of all the profits but does not have to share in the losses.

So I think government would be wise to reduce its redtape and its regulations and give business a little freer hand, because business brings in a great deal of the revenue to the Federal Government.

Thank you gentlemen, very much.

[The prepared statements of the preceding panel follow:]

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. Chairman and members of the committee, I am Peter McCloskey, president of the Electronic Industries Association.

The Electronic Industries Association (EIA) is the national organization representing the electronic manufacturers of the United States. EIA's 300 member companies range from manufacturers of the smallest electronic part to major corporations that design and produce the most sophisticated and complex systems used in our defense and space programs, as well as for commerical use in a variety of areas. Our member companies account for over three-quarters of the $64.9 billion electronic market, and are responsible for the employment of nearly 1.3 million Americans.

Our industry is very concerned about the Nation's declining productivity in comparison with our foreign competitors. We are also concerned that the U.S. technology base, once far superior to any other in the world, is now in danger of losing its competitive edge.

Recent data prepared by Professor John W. Kendrick indicates the primary sources of the recent slowdown in productivity to be:

(1) A slowdown in capital spending for research and development programs and new plants and equipment.

(2) Increased negative impact of government regulation.

(3) Increased impediments to capital and labor mobility.

Although productivity increases are stimulated by a number of complex factors, Dr. Dennison's seminal work cites technology innovation as being the most important means of achieving productivity gains. In fact, more than 50 percent of the increases in U.S. productivity can be attributed to technological innovation.

Innovation, the precursor to productivity growth, is itself fostered by a variety of factors. Clearly the most important is research and development. Innovation is the key to the correlation between R. & D. and productivity growth. Although the interaction of different influences and the various segments of the economy make it difficult to precisely quantify a given increment in R. & D. with a particular gain in

productivity, economists do not dispute the positive correlation between R. & D. and productivity growth.

Economic studies have found that industrial R. & D. expenditures have led to substantial productivity gains. This is not only for the industry conducting the R. & D. but for other industries as well, for two reasons: (1) the natural serendipity affect of research and development may result in breakthroughs more applicable to a completely industry, and (2) more fundamentally, technological innovation in capital equipment, such as computers and electronics, benefits the user industry products more directly than the manufacturer of the capital equipment. Economists have postulated that privately financed R. & D. tends to have greater economic benefits than federally financed R. & D.

Measurements of the relationship of R. & D. spending to the gross national product provide an indication, over time, of the relative priority given to the Nation's R. & D. effort. Total U.S. R. & D. expenditures accounted for 2.3 percent of the U.S. GNP in 1978, according to the National Science Foundation, and are expected to decrease to 2.2 percent in 1979. This ratio has been steadily declining from its 1964 high of 3 percent, largely because of the deceleration in Federal funding. Industry-funded efforts, while remaining essentially constant, have been unable to compensate for the Federal decline.

In 1968, the Federal Government financed over three-fifths of the national R. & D. effort, but by 1980 the Government is expected to finance less than one-half of the total. Since 1968, Federal defense and space R. & D. funds have been reduced. Beginning in 1976, Federal R. & D. funding began to increase in real terms, following the Nation's growing emphasis on energy development and conversation.

Industrial firms, which perform some 70 percent of all U.S. research and development, have been concentrating most of their R. & D. investment of the application of existing technologies toward product development and more near-term projects. Although many firms feel the need to conduct basic research in order to achieve important technological breakthroughs, economic pressures gives them little opportunity to take the risks required for investing in basic research. A number of disincentives force industry to rely on immediate pay-offs to R. & D., thus discouraging long-term basic research. These include the high cost of money, the recent Treasury rule 861 discouraging U.S. research and development, Federal regulation and its resultant costs in siphoning potential R. & D. money or focusing development activities on non-productive albeit socially desirable considerations.

Since the Government has only indirect control over such matters as the availability of venture capital, the competitive conditions in industry and the unique requirements of diverse markets, Government's most appropriate role in stimulating innovation would be through an investment tax credit. There are not enough planners in the world for Government to tell industry where to put its R. & D. dollars. And if there were, they would most likely be wrong. Those decisions must be made close to the market by entrepreneurs having a direct financial stake. While a tax credit would provide a stimulus, the impetus must come from the individual.

There is no simple solution to ending inflation and decelerating productivity. The bills before you (S. 700, S. 231, S. 1003, S. 1065) present a multi-faceted approach to stimulating and recreating a marketplace enviroment for an efficient and effective allocation of resources in the R. & D. area.

On behalf of the Electronic Industries Association, I wish to express my appreciation for the opportunity to work with Congress and applaud the efforts of this Committee to address this important problem. I respectfully offer whatever services of the Association that the Committee would find useful in the future.

Thank you.

Statement of John L. Nesheim, Treasurer, National Semiconductor Corp.

Summary of Principal Points

(1) The U.S. semiconductor industry faces a serious threat from Japanese competition. The threat exists because Japanese companies have a planned economy and receive research and development funds by borrowing amounts which would not be available in a free market economy. Japanese companies enjoy a debt equity ratio many times more favorable than that which is possible for U.S. companies.

(2) The Semiconductor Industry Association supports S. 231, S. 700, S. 1003, and S. 1065 as measures which are designed to stimulate technological innovation and development and to encourage U.S. industry to export.

(3) S. 700, which would make the investment tax credit available for research and development expenditures, and S. 1003, which provides tax incentives for exports,

are the two bills most specifically focused on the problems of the semiconductor industry, and would provide the greatest relief for our industry.

(4) Even with the help of this legislation, there is no way that U.S. industry can hope to match the capital formation advantages which Japan and other foreign governments provide to their exporters. The only adequate remedy is the bolstering and vigorous enforcement of our trade laws, to prevent unfair foreign competition. We recognize and appreciate the efforts of Senators on this committee in support of fair international trade laws.

Statement

My name is John Nesheim. I am Treasurer of National Semiconductor Corporation of Santa Clara, California which has annual sales in excess of $600 million. For the past 13 years, I have been helping finance the growth of international business, particularly industrial high technology companies. My experience spans years with Chase Manhattan Bank, with venture capital electronic companies, and with large multinational corporations. I earned an engineering degree from the University of Minnesota and a MBA from Cornell University where I majored in international finance.

I appear here today on behalf of the Semiconductor Industry Association, a trade association composed of 33 U.S. manufacturers of semiconductors.

Our association strongly supports the legislative proposals which are under consideration by this committee today. We believe that these four bills, S. 231, S. 700, S. 1003, and S. 1065 will help small business by permitting rapid recovery of capital investment and will stimulate and encourage research and development activities by businesses. Research and development is the life blood of high technology industries, and this is particularly true of semiconductors.

The legislation before the committee today will also facilitate basic scientific research by colleges and universities because one of the bills, S. 1065, will provide tax incentives for grants by corporations for basic scientific research. Moreover, this bill will have the effect of increasing research opportunities for U.S. engineering and science students, thereby increasing the pool of talent available to high technology industries.

Also, the legislation before the committee will help to encourage exports by U.S. businesses. S. 1003 is particularly designed to have this effect. Substantial exports are highly important if the United States is to retain its advantage in semiconductors and other high technology industries and will also help the United States solve its critical balance of payments problem.

In my testimony today I would like to explain briefly the threat which confronts the U.S. semiconductor industry in the form of unfair foreign competition which is often supported by foreign governments which place a high priority on export industries. I would also like to discuss the critical role of capital formation in high technology industries, and explain the difference between capital formation in a free enterprise economy, such as that of the United States, as opposed to the situation in a plannned national economy. Then I would like to comment more specifically on the legislation before the committee today, and explain how this legislation will help our industry, and other similar industries.

Export problems of U.S. semiconductor industry

A. *Restricted market access in Europe.*—Even while maintaining a very high tariff rate of 17 percent on imports of semiconductors into the European Economic Community, the Europeans have systematically taken a series of nontariff actions which impede imports even further. For example, European nontariff barriers include pressure on users to purchase from domestically owned companies and discriminatory rules of origin under which tariffs can be imposed if foreign semiconductor content in equipment exceeds a specified level. The policies are clear in most countries that domestic investment is required. There have also been massive grants—perhaps in an aggregate amount of as much as $900 million—and government supported loans by various European governments to their domestic semiconductor enterprises, to develop consumer and industrial products.

B. *Denial of market access in Japan.*—It is fair, I believe, to characterize the Japanese semiconductor market as having three salient characteristics:

(1) The Japanese have purchased our technology and otherwise acquired it through our universities, technical conferences and equipment suppliers;

(2) The Japanese have purchased our more sophisticated integrated circuit products, but only until they can produce the same product themselves, whereupon they effectively close their market; and

(3) At critical times, the Japanese, with rare exceptions, have effectively prohibited both construction of foreign-owned plants in Japan and foreign investment in existing Japanese semiconductor facilities.

These characteristics considered against the background of the export oriented Japanese semiconductor industry, set the state for considerable friction between our respective industries.

There are a number of different approaches to business between the Japanese and us which should be taken into account in considering the semiconductor industry:

Japan's government directs and supports certain industries targeted for growth, and several years ago "targeted" the integrated circuit, telecommunications and computer industries.

Japanese enterprises are highly leveraged through loans by the Japanese banks which are closely controlled by the government and are frequently related to manufacturing enterprises.

Japanese semiconductor enterprises are not dependent on the equity market to finance growth and hence do not have to achieve a high rate of return in order to attract capital.

The quasi-national bank credit system permits the enterprises to finance long-run deficits necessary to penetrate foreign markets.

Japan's home market is highly protected by a variety of barriers, "Buy Japan" attitudes and restrictive business practices.

Japan frequently has two-tier pricing in target industries—a high price in the protected home market and a low foreign price designed to capture market share.

As part of its targeting of the electronics industry, Japan's government subsidized a massive research effort aimed directly at a commercial objective.

These policies have been particularly effective in accelerating the development of the Japanese semiconductor industry. New U.S. high technology semiconductor devices have been designed into Japanese equipment, only to be displaced in large part by Japanese-made devices which duplicate the U.S. product. Virtually every type of semiconductor product in use today in Japan—including diodes, transistors, bipolar ICs and MOS circuits—was initially imported from United States companies.

Imports from Japan

In Japan, domestic trade in targeted manufactured goods is the residual or an extension of export activities—rather than the other way around. This particularly true in the semiconductor industry. Its acquired technological base, its target industry approach and its subsidized R. & D. are all aimed at penetrating export markets for semiconductors—principally the United States—in the same manner as it penetrated export markets for steel and consumer electronic products.

A. *Japan's technology base.*—Japan's position in the integrated circuit industry is based on technology acquired principally in the United States. Basically, Japan purchased our R. & D. at bargain basement prices and has concentrated its efforts on commercial development of our ideas in areas where high volume production can be achieved—what I would call "our bread and butter" products. But even this development work is expensive and the government has assisted the effort.

B. *Government-Assisted R. & D. for intergrated circuits.*—Using this substantial acquired technology as a base, the government, through the Ministry of International Trade and Industry ("MITI"), channeled research funds toward development of integrated circuits. The most significant of the research projects is the Very Large Scale Integration or "VLSI" study which MITI funded together with contributions from the leading Japanese electronics firms who would share the benefits of the research.

Let us examine for a moment the VLSI program. According to press reports, [1] it involves matching government funds to five large Japanese electronics companies: Fujitsu, Hitachi, Mitsubishi, NEC, and Toshiba.

The total cost announced publicly is $360 million, of which the government assisted portion is approximately $250 million. A key part of the program is MITI's own Electrotechnical Laboratory, the operating costs of which may not be a part of the budget figures I just mentioned. This is simply a form of government assistance to Japanese industry which permits the Japanese companies to sell their goods at lower margins.

C. *The target industry approach.*—The entire Japanese electronics industry is largely geared toward export markets. The Japanese have manufacturing capacity which far exceeds the needs of the domestic economy. They staff their factories to achieve a high percentage capacity utilization and consider their employees lifetime

[1] See "The Gathering Wave of Japanese Technology," Electronics, June 9, 1977, p. 99.

commitments of the enterprise. These fixed costs (indeed, all overhead costs) are covered by artificially high domestic prices in the protected home market.

Let me remind you of the impact which this system had on our television industry. While American consumers were paying $350 for a Japanese television, the Japanese consumers were paying $700 for an equivalent unit. United States television manfacturers are effectively denied access to the Japanese market, resulting in a protected, noncompetitive market which generates substantial profits. The Japanese then set U.S. prices as low as necessary to gain market penetration, on the premise that export sales need only cover incremental variable costs. Our television industry was shattered and its profitability has never recovered from the flood of imports.

During an economic downturn, the two-tier pricing structure and the protected home market allow the Japanese—motivated by their heavy fixed obligations and guaranteed employment—to flood the export markets with products far below the U.S. market price. This is exactly what happened in television and steel during the downturn in 1974 and 1975—when world economies softened, the plants kept rolling with excess production sold abroad at whatever low price was necessary. If this pattern is repeated in the semiconductor market during a future recessionary period, the U.S. market would be flooded with underpriced Japanese integrated circuit and LSI products. American companies, having limited access to the Japanese market and faced with falling prices and bookings in the U.S. market and with rising inventories—and lacking government financial support—would find that their investment capital has been drained away, thereby prohibiting expenditures on longrange R. & D. which are so essential for survival of a high technology growth industry.

The role of debt in Japanese capital formation

It is fundamental to the American capital markets that profitable companies can grow faster through the use of borrowed monies. In a free market system, borrowings, together with interest, must be repaid from the earnings of the borrower. Further, in a free market system, borrowings must have a foundation of equity or risk capital. The larger the proportion of debt to equity there is, and the smaller the amount of equity the greater is the risk of default, i.e., inability to repay the debt from the earnings of the company or from the equity base. For a given amount of equity, the more debt one has, the more capital (debt plus equity) can be raised. The ratio of debt to equity is called leverage.

The benefits of leverage can be great. For example, large amounts of debt can compensate for inefficiently run—or noncompetitive—companies. The return to shareholders can be boosted sharply and quickly by an injection of debt. High returns on shareholder's equity can be earned by three different means:

(1) High efficiency and excellent manufacturing that produces a high level of earnings;

(2) Aggressive marketing which generates a large amount of sales for each dollar invested in the company; or

(3) Extremely high proportions of debt per dollar of equity which can protect a less efficient company.

United States companies currently have about double the return on equity of Japanese competitors. Such levels of earnings are necessary to finance new R. & D. to pay for the latest sophisticated equipment, and to provide for increased capacity to manufacture new products.

Exhibit 1 shows that the earnings of U.S. manufacturers are three times as much per dollar of sales as their Japanese counterparts. That level of earnings is necessary in a free market economy to attract fresh capital to this industry which has rapid advances in its technology and must continually develop and market products which incorporate newer, better ideas.

United States companies have 60 percent to 100 percent more sales per dollar of capital than the Japanese companies. This indicates a very effective and efficient use of assets by the U.S. companies—a higher level of technological efficiency. Command of complex manufacturing processes is the key here. Should the U.S. lead in technology falter, there would be a domino effect, causing return on equity to fall and subsequently causing a sharp reduction in the amount of capital which could be attracted to the industry. Then growth would slow, including noticeable reductions in both exports and employment.

In light of the present record of excellent performance, one might ask why U.S. companies are concerned? Good management plus control of technology make a winning combination. Well, that sounds fine, but in addition to people and equipment, there is a critical third ingredient: cash. In more formal terms, capital formation.

The Japanese understand this well. In fact, they play catch-up by borrowing 2, 20, even 40 or more times as much debt per dollar of equity as would be available in the free capital markets. This aspect of their planned economy gives them a distinctive competitive edge. If there is any doubt that the Japanese economy is planned, let me read you a quotation of Hiroshi Kawasaki, of the International Trade Policy Bureau of MITI:[2] "American business must realize and accept that Japan is not really a free economy. It is a highly planned economy * * *."

The U.S. system compared

So why do U.S. companies not counter such a competitive more by borrowing equally large amounts? After all, as Exhibit 1 shows, using Japanese proportions of debt would more than double the return on equity for a U.S. company.

The answer is our free market economy. In general, the U.S. companies raise cash in the open, competitive markets in the United States. Capital formation, the key to growth, depends in our country on our free capital markets which allocate investment funds among competing applicants. American bankers make loans to companies that are on their own to live or die in the free marketplace, openly competing against any challenges. Some win and grow profitably. Others lose and go bankrupt. Once bankrupt, U.S. companies cannot expect the U.S. Government to bail them out by instructing banks not to foreclose on loans.

In the Japanese system, that is not so. Large companies that get into financial difficulty have an assured source of substantial financial help from the Japanese government. Moreover, business recessions in the protected Japanese home market are virtually nonexistent compared with those in America. America to a large extent absorbs Japanese unemployment.

That is why American bankers will lend only a fraction of the debt to U.S. semiconductor companies that Japanese bankers supply to Japanese companies. In fact, if you ask U.S. bankers with branches in Japan how they can justify lending as much debt to Japanese companies which have a very thin equity base, they all eventually get around to the concession that the risk in such loans is not a risk in an individual company, rather it is a loan whose risk is a country risk: Japan. Such actual or implied governmental guarantees make a susbstantial difference.

There is a further concern that U.S. high technology companies have: lower margins on sales. For example, a foreign company can try to buy a share of the market by reducing prices sharply. Undercutting U.S. prices in the large, fast-growing U.S. market for semiconductors is such an example. Such a threat seriously jeopardizes capital formation processes in the United States. For instance, if American companies have to meet Japanese prices and thus cut earning margins to Japanese levels, then the return to shareholders will be cut by half, three-quarters or more and perhaps eliminated, as shown in Exhibit 1. Nippon Electric Company, a large Japanese semiconductor producer, announced profits for fiscal 1979 which constitute a return of 1.2 percent on sales.[3] American companies could not survive for long with such a low return. Lower earnings from reduced prices are not a problem for the Japanese companies, however, as they have a pipeline to the banks and do not raise capital in competitive markets.

If foreign competitors are allowed to engage in economically unrealistic price-cutting tactics, as happened in the television industry, it could be catastrophic for the U.S. semiconductor industry: No more new capital, slower growth, less earnings, lower motivation for employees and another U.S. high technology industry bites the dust.

The Japanese semiconductor spokesmen have expressed concern about the "worldwide tendency toward protectionism." This generalizaation simply fails to distinguish between an action and a reaction by the domestic industries in markets invaded by the Japanese. What they are seeing is a reaction to their grossly unfair international trade practices.

In contrast, they have acted initially in the most fundamental protectionist manner by a series of formal and informal trade barriers unprecedented for a developed economy of the 1970's.

I wholeheartedly agree with Senator Bentsen, who summarized the issue so eloquently in a speech on the floor of the Senate on May 3, 1979:

"Trade between nations is becoming an increasingly carnivorous activity, and the traditional free trader has all the advantages of an antelope in a world of lions."

"We can no longer tolerate situations in which foreign competitors utilize unfair trade practices to rout and destroy a domestic industry, such as television, and remain immune from punishment until they have achieved their objective."

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[2] *Industry Week*, p. 37 (Jan. 9, 1978).

[3] New York Times, Saturday, May 26, 1979.

The legislation before this committee will stimulate capital formation for U.S. industry

I would now like to comment in detail on the legislation which is before this Committee today, and explain how enactment of these proposals will help to alleviate some of the problems I have just outlined.

S. 231 would aid capital formation by increasing the Asset Depreciation Range variance from 20 percent to 30 percent and by providing a simplified straight line depreciation table for small businesses which have an adjusted tax basis in assets of $250,000 or less.

This legislation is not specifically aimed at the problems of high technology industries, but would certainly help high technology businesses, as well as other industries, by allowing a faster recapture of investments made in plant and equipment. One of the problems for the semiconductor industry is that the technology changes so rapidly that some plant and equpment quickly becomes obsolete. Therefore, our industry believes that an increase in the ADR variance would not only be helpful, but would also be more realistic in terms of needs of our industry for rapid replacement of equipment because of technological innovation. Also, the proposal would permit a more rapid write-off of equipment which is used in research and development activities. Moreover, many of our suppliers are relatively small businesses which would benefit greatly from this legislation.

The proposal for a simplified depreciation table would probably not help established businesses, due to the $250,000 limitation. But the proposal might be of some benefit to new venture-capital businesses getting started in high technology industries. We not particularly that the proposal to allow a 2-year useful life for information systems, computers, and other data handling equipment would be of great benefit to new enterprises in high technology industries.

We believe that this legislation will help to stimulate small business. In a high technology field, such as ours, proposals which stimulate small business also benefit larger more established companies, because much of the pioneer technological research and ideas come from new business ventures.

S. 700 would permit the 10 percent investment credit to be available for research and development expenditures. This legislation would be of substantial assistance to the semiconductor industry and similar industries which are engaged in a constant technological struggle with foreign competitors, many of whose governments provide substantial direct and indirect assistance for technological innovation.

As Senator Danforth said in introducing this legislation: "It is widely recognized that one of the contributing factors of our declining foreign trade position is the erosion of the technological advantage that U.S. industry has historically enjoyed vis-a-vis the rest of the world. A related problem is the marked slowdown in the growth rate of U.S. productivity (economic output per unit of labor force imput). I am convinced that both of these economic problems are, to a significant degree, directly related to the sluggishness in this country's commitment to research and development investment and the simultaneous upswing in R. & D. investment by our major trading partners."

This statement, in our view, concisely and accurately summarizes one of the major problems faced today by United States industry in general and by high technology industry in particular.

We further submit that the purpose of the legislation, to allow the investment credit for research and development expenditures, is consistent with the basic purpose of allowing an investment tax credit for machinery and equipment. The investment tax credit, as embodied in the law today, serves a number of purposes. It creates jobs by stimulating investment. It increases productivity by making available to businesses a source of capital to modernize their plants. Finally, the investment tax credit is one means of helping U.S. businesses remain competitive with foreign companies, many of whom receive substantial investment assistance from their own governments.

An investment tax credit for research and development expenditures would stimulate jobs directly and indirectly. Direct stimulation would occur through increased expenditures by U.S. businesses for research and development. Indirect stimulation would occur from the technological breakthoughs resulting from the research and development. New products, new technological innovations and, indeed, whole new industries might well be created as a result of increased research. Conversely, if the United States falls behind foreign competitors in technological innovation, many U.S. jobs will be lost to foreign imports.

In the same regard, providing an investment tax credit for R. & D. expenditures will help to make available to U.S. businesses some of the capital which will enable the businesses to modernize and maintain our all-important technology lead.

For all of these reasons we strongly support S. 700.

S. 1003 is designed to stimulate the export of U.S. products by making three changes or clarifications in the tax law. First, a firm would be permitted to deduct, as a reserve for foreign bad debt losses, an amount equal to 15 percent of its taxable export income or 2 percent of the outstanding export credits appearing on its balance sheet at the end of the year. However, the total reserve under this provision may not exceed 5 percent of the company's outstanding export credits.

Second, the legislation would encourage exports by clarifying that amounts expended by a company for foreign market studies, foreign marketing expenses, including amounts paid to modify U.S. products to qualify them to meet foreign market requirements, as well as the cost of applying for and maintaining international and foreign patents, would all qualify as research and development expenditures, eligible for the election provided by Congress under Section 174 of the Internal Revenue Code.

This would be especially helpful in the face of objections, asserted by the Japanese, that U.S. industry does not succeed in Japanese markets because the U.S. business does not "understand" the Japanese market, or because there are "quality differences" in the Japanese and U.S. products. We note that the Japanese are usually reluctant to be specific about these quality differences.

Finally, the legislation would reduce problems of entering the export market based on concerns about currency fluctuation losses on export credits which had not been repaid by the end of the year.

We strongly support all of these proposals, which are designed to encourage U.S. exports. In our view, it is vital to the U.S. interest, and to the interest of U.S. industry, to become more competitive in international markets, especially in high technology industries.

S. 1065 would provide a Federal tax credit of 25 percent of grants made by corporations to colleges and universities for basic research. The credit would be incremental in the sense that it would be available only to the extent that basic research grants for the year exceeded average research grants made during a four-year moving base period.

This proposal will help to stimulate research in the basic sciences by encouraging corporate grants for scientific research. Therefore, we believe the proposal will further U.S. technological innovation by helping to create a base of fundamental research which business and industry can build upon in the field of applied science. Moreover, grants of this nature will increase the pool of talented highly skilled engineering students who will later become innovative leaders of U.S. businesses.

However, we note that, under the proposal, scientific basic research means research the results of which are made freely available to the general public. This presumably means that the results of the research would be available to foreign competitors, as well as to U.S. businesses.

Also, the incremental feature of the bill could result in problems. Under present law corporations are generally permitted to make tax deductible contributions to charity in an amount equal to only 5 percent of the corporation's taxable income. As a practical matter, unless a corporation making grants for basic scientific research had continually rising income, eventually it would bump against the 5 percent ceiling. When this happens, under the bill, the corporation could receive a tax credit for contributions in excess of the 5 percent ceiling, but would not be entitled to a tax deduction. However, if the corporate grants did not exceed the 5 percent deduction limitation, no credit would be available under the bill because the corporation's basic research grants would not exceed the level of grants during its 4-year base period.

There are several possible ways to improve this situation. One possibility would be to remove the incremental requirement from the bill. Another possibility would be to amend section 170(b)(2) of the Internal Revenue Code, to provide that amounts eligible for the basic research tax credit under this legislation would also be eligible for an income tax deduction without regard to the 5 percent limitation which normally applies to corporate charitable contributions.

CONCLUSIONS

The legislation which is before this committee will be of benefit to the U.S. semiconductor industry and to other high technology U.S. businesses. The legislation will help to stimulate capital formation for research and development and will also encourage U.S. penetration of export markets.

At the same time, it must be remembered that no amount of stimulus to capital formation can totally offset the tremendous amounts of capital which a planned national economy can make available to a preferred export-oriented industry.

We strongly support the four bills under consideration by this committee today and believe that they should be enacted. However, for our industry, this legislation, helpful as it is, is far from a complete solution to the problems which we face from unfair foreign competition.

This problem can only be met through strengthening and vigorous enforcement of the U.S. laws which require fair competition in international trade and which outlaw such practices as two-tier pricing. We are aware of the efforts of this committee to try and ensure that the U.S. trade laws are adequately enforced. We would like to express our gratitude for these efforts, as well as for the efforts in sponsoring the legislation before this committee

[Exibit 1]

COMPARISONS

	Return shareholders equity equals return on sales	Capital turnover	Leverage
U.S. company	16% = 6.3%	2.25	1 + 0.20
Japanese company	8% = 2.0%	1.45	1 + 1.75
U.S./Japan	2.1 3.2	1.6	0.1
U.S. company with Japanese leverage	39% = 6.3%	2.25	1 + 1.75
U.S. company with Japanese earnings	5% = 2.0%	2.25	1 + 0.20

CONCLUSIONS

American semiconductor companies earn more return on shareholders' equity than Japanese companies because of higher margins and more efficient use of invested capital.

Japanese companies have very low profit margins, use capital less efficiently than the U.S. companies, but make up lost ground through use of substantially higher amounts of debt per dollar of equity.

Good morning. My name is Harold J. Winch; I am President and Chief Executive Officer of The Minster Machine Company. Located in Minster, Ohio, we employ approximately 900 workers. I am representing the National Machine Tool Builders Association (NMTBA), a national trade association whose over 370 member companies account for 90 percent of the United States machine tool production. The U.S. machine tool industry currently employs approximately 97,000 workers.

We welcome this opportunity to assist this Subcommittee in its reassessment of the current U.S. capital cost recovery system, in an effort to encourage even greater capital formation, higher employment, and greater economic opportunity through a more productive industrial base.

Economists and the Government increasingly have come to acknowledge that the relatively small but essential machine tool industry is a most reliable barometer for measuring the economic health of the Nation, and for determining the impact and effect on industry of changes in the capital cost recovery laws. Therefore, we believe our testimony given today should be viewed in a larger light than just the machine tool industry. Moreover, any tax revisions impacting on investment capital will have resounding effect on this capital-intensive industry.

At the outset, we commend to this Subcommitee the concepts of accelerated depreciation methods and the investment tax credit as engines of productive growth in the American economy. Capital cost recovery has been, and continues to be an extremely effective method of encouraging critically necessary capital investment in the U.S. economy.

Before specifically addressing the depreciation reform bills currently before this Subcommitee, we would first like to briefly comment on the very substantial effect that capital cost recovery and depreciation tax policies have upon productivity and inflation in America.

For the past decade we have all been bombarded with talk about the causes of inflation. There is cost push inflation; there is demand pull inflation; there is the wage-price spiral. All of these theories are probably partially correct. However, within the relationship between costs, wages, prices, and productivity lies a weapon that can be used to counteract the insidious damage that inflation is causing.

The ultimate result of inflation is increasing prices. And in manufacturing, or any business for that matter, prices have three major elements: the cost of purchased components; the cost of labor; and the cost of all other nonlabor payments.

Nonlabor payments are the sum of profits plus such non-labor costs as interest, depreciation, rents and royalties, taxes, regulatory and inspection fees, etc. Chart 1 illustrates how each of the main elements of nonlabor payments are related and how inflation has affected them.

Chart 1 also shows, rather dramatically, that every element in the nonlabor payments of American businesses has increased substantially, with the single exception of profits. As a matter of fact, the relative decline in profits compared to other non-labor cost factors has had a dampening effect on inflationary pressures.

The second element is the cost of labor. Unit labor costs are what we pay our workers, divided by the real value of their output.

The final element, the cost of purchased components, is a passthrough item that has little effect upon the ultimate price of a nation's manufacturing output. As a result, it is the total labor and non-labor costs and payments, by everyone in the stream of commerce, that finally determines the price of goods.

Therefore, when we look at the costs that affect prices for all manufacturing, we need to study just two factors: unit labor costs; and unit non-labor costs.

In examining how these two factors have reacted upon prices, we begin by looking at Chart 2 which starts in 1955—just after the Korean War and its post-war recession.

During the first 3 years, until the 1958 recession, nonlabor costs for taxes, interest, etc., were rising at a rate of less than 1½ percent per year. They would have risen faster but, as Chart 2 shows, business was settling for lower profits in an effort to restrain price increases.

This was true because unit labor costs were climbing at an average rate of almost 4½ percent per year. Unit labor costs could have risen even faster, but we were able to offset much of the increase in labor rates by an average annual growth in productivity of more than 2 percent.

Of course, with unit labor costs rising and with unit non-labor payments rising, prices charged for manufactured products had to rise. And they did; at a rate of about 3 percent per year, beginning an inflationary period.

Continuing our analysis, during the years 1958 through 1965, nonlabor payments continued to climb at a modest rate of about 2 percent per year and business profitability was recovering. However, when we look at unit labor costs we note that they were constant during this period.

The key to our success in keeping labor costs under control for seven years, in spite of wage increases which occurred during the early 1960's, was productivity growth. During the 7-year period from 1958 through 1965, productivity grew at an average annual rate of 3½ percent, completely offsetting the increases in workers' wages and holding unit labor costs in manufacturing at a constant level.

The benefit of stable labor costs over this period was reflected in the stable price level. In fact, the average annual increase in wholesale prices was less than one-half of 1 percent. That is less than today's monthly inflation target.

From this discussion we conclude that if reasonable wage increases are balanced with adequate productivity gains, the result is constant unit labor costs. And if unit labor costs are constant then everyone gains because prices are stable, profits rise for business, tax income rises for government and real spendable income rises for workers. All of these things happened in the early 1960's.

Unfortunately, in the mid-1960's the economy lost this former stability. First, productively growth began to falter—declining to an average annual growth rate of about 2 percent—down nearly one-half from the productivity improvement rates of the first half of the decade.

Wages began to accelerate. And without additional productivity growth, unit labor costs began to increase dramatically. In fact, during this period, unit labor costs were increasing at an average rate of about 5 percent per year.

In contrast, nonlabor costs remained almost constant. Throughout the entire period, taxes, interest and other costs were rising—but American businesses, in an effort to counteract the rapidly rising unit labor costs, were again forced to cut their profits to stem price increases and remain competitive. Nevertheless, rising labor costs forced prices upward at an annual rate approaching 3 percent, sowing the seeds of today's inflationary problems.

Then came the 1970's. Productivity growth in the private economy came to a near standstill—rising at a rate of only 0.9 percent per year over the last past 5 years.

Of course labor rates skyrocketed—fueled by inflationary expectations and a "catch-up" philosophy. As a result, unit labor costs have been rising at an average

annual rate of 7.9 percent during the last half decade. And remember, unit labor costs made this dramatic increase even though we experienced a severe recession, coupled with unusually high unemployment.

Taxes, interest and all of the other nonlabor costs of running a business were also leaping upward at an unprecedented rate of 8.2 percent per year. And, as we all know, the result was dramatic 9 percent rise in prices.

From this economic history we have learned two very important lessons. First, that as unit labor costs increased prices also went up.

Secondly, and this is the point we wish to strongly emphasize to this Subcommittee, that wage increases are not, necessarily, the inflationary culprit, because with rapidly rising productivity it is possible to offset increasing wage rates, this dampening—or even eliminating—unit labor cost increases.

In other words, one way to bring prices under control—either as a Nation, as an industry or as an individual company—is to increase productivity faster than total wages.

Chart 3 shows the productivity growth of America's total private business sector and the driving force that pushes productivity upward—investment. For more than 25 years our national growth in productivity has traveled hand in hand with investment. Whenever we increase our investment in more efficient equipment, our productivity improves. And furthermore, when we invest in new, more productive equipment, we produce higher quality products and all the people of America benefit. When people work smarter, by using machinery that works harder, they earn more real income. Which brings us back to the purpose of our comments before this Subcommittee, specifically, improving the capital cost recovery system, so that American industry can once again increase its investment in new productive capital equipment.

Although we are very pleased by Congress recognition of this critical need for improved investment incentive which has been reflected in the adoption of accelerated depreciation methods and the ADR's along with the increase of the investment tax credit from 7 percent to the present 10 percent level, we still feel it imperative that more be done to increase productivity, thereby allowing business to combat the current double-digit inflation.

Thus, the depreciation reform bills before you today must be viewed not as tax incentives nor as "tax expenditures"—but as weapons in the war on inflation.

In 1978, NMTBA conducted a study of 16 major metalworking companies annual reports. Without question, the companies selected are leaders in their industries. Ten of them are in the top hundred of the Fortune 500. And every one of the 16 would be considered a Blue Chip on Wall Street.

The results of this study were presented to the Finance Committee in testimony given last year and were referred to by Senator Chafee in the intorductory remarks to his bill, S. 935, entitled the "Capital Cost Recovery Act of 1979." [1]

In summary, those results reflected a capital spending history that exhibited the beneficial effect of the confidence and stability of the early 1960's. Then capital expenditures stopped rising and hit a plateau that lasted 7 years. In 1973 capital spending took off again, but gains were almost completely wiped out by inflation. Actually, real capital spending has been declining steadily since 1965.

This decline is even more dramatic when considered in light of the fact that during this period sales were rising. When viewed as a percentage of sales, the portion of every dollar reinvested by these companies since 1965 has fallen nearly 40 percent, from 6.6 percent to 4. 1 percent.

In short, since 1970 America's metalworking industry has been in unconscious and involuntary liquidation. And the same probably holds true for almost all of America's manufacturing industries.

It is time that we clear the air and stop liquidating America's industrial base so that we can modernize and grow—thereby making America once again fully competitive in world markets and providing the capital equipment needed to create jobs for all Americans.

Either of the depreciation reform bills recently introduced by Senators Chafee (S. 935) and Bentsen (S. 231) if enacted into law would be major steps toward providing the type of atmosphere necessary for the revitalization of American industry. [2] We commend both Senators for their insight on this issue.

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[1] U.S. Congress, Senate, A bill to amend the Internal Revenue Code of 1954 to provide an election to depreciation property eligible for the investment credit over 5 years, to allow amortization of pollution control equipment over 2 years, and for other purposes, S. 935, 96th Cong., 1st sess., 1979, Journal, Apr. 10, 1979, pp. 4306.

[2] U.S. Congress, Senate, A bill to amend the Internal Revenue Code to help increase productivity and reduce inflation by providing larger tax deductions for depreciation, S. 231, 96th Cong., 1st sess., 1979, Journal, Jan. 25, 1979, pp. 689-91.

While the provisions of the two bills differ somewhat, their underlying message is the same: America must do what is necessary to increase internal capital formation to permit industry to more quickly recover its capital investments.

Senator Bentsen's bill takes a three pronged approach providing: One, an increase in the ADR system (Asset Depreciation Range) from its present level of 20 percent to 30 percent; two, a simplification of the ADR so that more taxpayers will take advantage of the system; and three, a simple depreciation table for small business.[3]

Senator Bentsen is to be commended for these reforms. The NMTBA has long advocated increasing the current 20 percent ADR to at least 30 percent as one means of raising the amount of funds business can internally generate for capital spending.

We respectfully suggest that the possibility of extending the ADR even further to 40 percent be considered, so as to make possible greater investment in more productive equipment, thus curbing inflation.

We further commend Senator Bentsen for his bill's provision which would give small firms the flexibility to choose shorter than normal useful lives for assets, the concept being that the present value of the economic benefits of straight line depreciation using those lives would be equivalent to the benefits which larger businesses obtain by using ADR lives and double declining balance depreciation. We are also gratified to note that the qualifying asset tax basis has been set low enough so that more than 90 percent of all businesses will be eligible to benefit from these investment incentives. Moreover, the use of shorter asset lives under Senator Bentsen's bill apparently will not affect the ability of small businesses to use the investment tax credit which would have been available if they had used the longer normal ADR lives.[4]

In addition to this provision we would recommend that more rapid amortization be given to companies in industries where rapid technological changes quickly make recently purchased equipment obsolete. For American industry to maintain its technological leadership and improve its competitive position in world markets this obsolescent equipment must be replaced by the newest and best available. However, making these investments requires a large enough reserve of funds for capital spending. A realistic depreciation schedule is one method of assuring American industry that the cash flow needed for the purchase of new capital goods will be available. The largest boon of changed depreciation allowances is that the required funds can be largely internally generated.

Either program, increasing the ADR or shortening depreciable life spans, will permit business to generate the funds to be appropriated for capital spending out of its own operations.

Turning now to Senator Chafee's bill, we note that it would: One, allow depreciation of tangible personal property, such as machine tools over a 5-year period; two, leave current rules for depreciation of shorter lived equipment (3 years or less) unchanged; three, leave rules for application of the investment tax credit unchanged for the above (one-third credit for depreciation over 3 and 4 years, two-thirds credit over 5 and 6 years, and the full 10 percent credit for depreciation over 7 or more years); fourth, allow depreciation of Government-mandated pollution equipment in 2 years with the full investment tax credit; and fifth, continues to allow the use of standard accelerated depreciation accounting methods as currently provided by law.[5]

Senator Chafee's proposed legislation is to be commended for its encouragement of inflation fighting capital investment. However, we would recommend two modifications of S. 935 which would make it an even more effective spur to greater productivity and lower inflation.

First, we would strongly urge that the full 10 percent investment tax credit be made available to companies even when they opt for the shorter 5-year depreciation period.

Second, we are very pleased to note Senator Chafee's recognition of the fact that Government-mandated pollution equipment expenditures constitute a tremendous capital expense for companies, by virtue of his inclusion of a 2 year amortization period, at the full 10 percent investment tax credit level, for such legally required expenditures. However, we would strongly recommend that this provision both be shortened to a one year write-off period and broadened to include all Government-mandated equipment, (i.e., OSHA required safety equipment, etc., as well as pollution controls). This modification is especially important due to the fact that most of

[3] Ibid., p. 689.
[4] Ibid.
[5] S. 935, 96th Cong., 1st. sess., 1979, Journal, Apr. 10, 1979, p. 4306

this type equipment, while sometimes providing a more healthful environment, hardly ever contributes anything to increased productivity.

In conclusion, improving the cash flow of industry through the changes provided in these bills has never been more important that it is in today's inflationary times. As demonstrated by our example of the 16 metalworking firms, current capital spending recovery mechanisms are inadequately dealing with the rising prices of new productive machinery. Every year that the recovery of a portion of the original capital outlay is postponed translates into a further shortfall between the cash flow generated by depreciation and the actual outlay needed to replace the depreciated equipment.

The key feature to any of these changes in depreciation allowances is that they would attempt to treat capital spending in a more progressive sense. Depreciation charges generated by capital spending would be treated more rationally as a cost of doing business rather than simply as a tax allowance for the wear and tear on equipment which is now the effective case. A depreciation policy that allows business to more fully recoup the replacement cost of aging capital equipment over a shorter time span also means that a firm's operating profits would not have to be utilized to replace obsolescent machinery.

The current practice of inadequate depreciation allowances creates phantom profits, as depreciation expenses are far too low, and artificially inflates profits at the bottom line of a firm's income statement. The changes we recommend would simply move the source of funds used for capital spending out of the retained earnings ledger back into the depreciation expense accounts where they more accurately belong. Such a change in tax policy would reduce the tax liability of the average firm but the tax reductions would not be unjustified. The tax applicable to the firm's reduced earnings would then be a true tax on profits not an unwitting tax on improperly amortized capital assets.

Implementation of policies designed to make it possible for American industries to increase their capital stock are important, not only to the machine tool industry, but to the Nation's general economic welfare. The tax changes Senators Bentsen and Chafee propose will promote the investment needed to boost lagging productivity, create new jobs, reduce inflation, and generate the level of economic activity which will promote the balancing of the federal budget. A tax policy which recognizes capital accumulation as the corner stone of our industrial society is needed to prevent the economy from falling into a pattern of unacceptably slow or negative growth. These changes would also re-establish the United States as the world's leader in technology and economic strength.

Thank you for the opportunity to testify before this Subcommittee. We would be happy to answer any further questions at this time.

CHART 1

NON-LABOR PAYMENTS

(CAPITAL CONSUMPTION ALLOWANCE, NET INTEREST, NET PROFITS, & TAX ON PROFITS + INDIRECT TAXES FOR NON-FINANCIAL CORPORATE SECTOR)

$ BILLIONS

200
180
160
140
120
100
80
60
40
20
0

TAXES
DEPRECIATION
PROFITS
INTEREST

50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80

Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF ECONOMIC ANALYSIS

CHART 2

COSTS, PRICES & PRODUCTIVITY

(UNIT LABOR COSTS, UNIT NON-LABOR PAYMENTS, WHOLESALE PRICES, AND OUTPUT PER HOUR FOR NON-FINANCIAL CORPORATE SECTOR)

INDEX (1955 = 100, RATIO SCALE)

230
220
210
200
190
180
170
160
150
140
130
120
110
100

PRODUCTIVITY
LABOR
PRICE
NON-LABOR

56 58 60 62 64 66 68 70 72 74 76 78 80

Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE. BUREAU OF ECONOMIC ANALYSIS

CHART 3

PRODUCTIVITY & INVESTMENT

(OUTPUT PER HOUR & NET CAPITAL STOCK ADDITIONS PER HOUR FOR TOTAL PRIVATE BUSINESS)

INDEX (1950 = 100, RATIO SCALE)

200
190
180
170
160
150
140
130
120
110
100

PRODUCTIVITY

INVESTMENT

50 52 54 56 58 60 62 64 66 68 70 72 74 76 78 80

Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF LABOR STATISTICS

Senator BYRD. Next we will have a panel of three: Mr. John McKelvey, Midwest Research Institute; Charles F. Hilly, vice president, government relations, SRI International; and Mr. Paul D. Seghers, president, International Tax Institute. Welcome, gentlemen. You may decide among yourselves who will proceed first. The first on the list is Mr. McKelvey. You can work it out.

[The prepared statement of John McKelvey follows:]

STATEMENT OF JOHN McKELVEY, PRESIDENT, MIDWEST RESEARCH INSTITUTE

Mr. MCKELVEY. My name is John McKelvey, and I am president of Midwest Research Institute, Kansas City, Mo. We are about the third largest nonprofit research institute in the country and among our specialties are research into economics, energy, health, the environment, and other similar areas.

One of our primary efforts is in the field of alternative energy sources. We operate the Solar Energy Research Institute for the Department of Energy and have a number of other energy-related projects.

Let me begin by saying I am here in support of S. 700 and S. 1065. Those bills have been looked at carefully by our economists, long-range planning experts, and our financial analysts. Their conclusion, and mine, is that these bills offer creative and positive economic benefits for our country. It is exactly the kind of help that the Federal Government should be providing to aid the economy.

They are steps away from controls and restrictions. They are steps toward the creation of new jobs. They are steps that encourage innovation, invention, and investment in ourselves.

In analyzing S. 100, we looked at its potential effects on both exports and energy. Those subjects were noted specifically by the chairman of this subcommittee in ordering this hearing.

Based upon our review of the U.S. trade position and our extremely delicate energy situation, I believe there is a direct relationship between the need to develop a trade policy that stimulates exports and an energy policy that reduces petroleum imports.

S. 700, through the tax incentives it provides, would help meet that goal. It would stimulate research and development by the private sector in a wide variety of ways.

One would be the development of technologies that lead to products for export. Another would be an immediate increase in private research into alternative energy sources, and success there translates into reduction of petroleum imports.

The combination of these two—more exports of technology-based products and fewer imports of petroleum products—should mean an improved balance of trade. It also means more jobs for Americans, and that is something we all want to see.

S. 700 provides a 10-percent tax credit for research and development expenditures. In my opinion, that tax credit is needed to reverse an unhealthy trend that has been developing for more than a decade and a half. That trend has been a steady decline in real expenditures for R. & D.

As Senator Danforth pointed out when he introduced this bill, the Federal Government spent more in real dollars for R. & D. in

1962 than it did in 1978. Private sector R. & D. investment has not done much better.

By giving the private sector a real incentive to invest more heavily in R. & D., both 700 and S. 1065 will be saying the problem has been recognized and a cure is at hand. For example, erosion of our technological advantage is a major contributing factor to our declining foreign trade position. Other countries are rapidly catching up in terms of advanced technology.

Tied to that is productivity, the economic output by a worker. Our productivity growth rate is slowing, while that of foreign competitors has been increasing.

I believe that both of these negative factors are directly related to our failure to maintain a strong commitment to R. & D. investment. We still lead the world in innovative technology. That lead can be lost, and will be lost, if we fail to act.

Our major foreign competitors, West Germany and Japan, are devoting more and more of their resources to R. & D. In Japan, for example, worker productivity continues to increase at 4.2 percent annually, and it is even better in Europe. It is 5 percent in France and 5.7 percent in West Germany.

Compared that to a productivity increase of 2.3 percent through the 1970's by American workers. Even worse, compare it to a 3.4 percent increase by American workers during the 1960's.

We are not only failing to keep pace with foreign competition; we are not even keeping pace with ourselves.

Here is some other numbers that I find troubling.

I think they are solid evidence that we are, in fact, facing heavy competition from foreign R. & D. U.S. patents granted to foreign interests increased 19 percent between 1966 and 1967. At present, 37 percent of all new U.S. patents are being issued to foreigners.

The answer to what is happening to American technology is clear. We are investing too little in R. & D., too little in basic research. There is a direct correlation between an industry's R. & D. investment and its world market share.

But there has been virtually no growth in R. & D. spending in the United States for the past 10 years. The National Science Foundation data show that R. & D. was 3 percent of our gross national product in 1964, 2.2 percent in 1977 and will be 2 percent by 1985.

Even worse, in terms of constant dollars, 1977 R. & D. outlays were 4 percent below those in 1967.

Most of the basic research in this country is done in colleges and universities and they rely on the Federal Government for two-thirds of their budgets. Such Federal support has barely kept pace with inflation over the last decade and, in addition, basic research spending by industry has fallen 20 percent in 10 years.

That trend is particularly discouraging, because basic research is the long-term work that leads to future scientific and technological innovations.

The formula is simple: less basic research, less innovation and invention.

In light of these trends, the alternative approaches for encouraging R. & D. investment that are at the heart of S. 700 and S. 1065 become more important than ever.

S. 700 would allow R. & D. expenditures to be treated exactly the same as new equipment. In other words, it says innovative ideas are as important as machinery.

Acceptance of that concept is essential to our future.

S. 1065 is equally important. By providing an incentive for basic research by colleges and universities, our long-term technological future is enhanced.

S. 1065, by providing a tax credit for corporations to give basic research grants to colleges and universities opens up a significant new source of funds, private funds that could both complement and supplement Federal funds.

I am firmly convinced the two bills, S. 700 and S. 1065 should receive rapid and favorable consideration. They not only provide an incentive for R. & D. spending, but they also would provide a specific incentive for R. & D. aimed at developing domestic alternative energy sources.

I cannot stress too strongly the energy aspects of these bills. The Congress provided a tax incentive for energy-related equipment and materials through the Energy Tax Act of 1978 and the President's proposed "Energy Security Fund" would provide similar energy-related tax credits. But neither measure has any real effect on R. & D. S. 700 and S. 1065 will.

Thank you.

Senator BYRD. Thank you, Mr. McKelvey.

[The prepared statement of Mr. McKelvey follows:]

STATEMENT OF JOHN MCKELVEY, PRESIDENT, MIDWEST RESEARCH INSTITUTE, KANSAS CITY, MO.

Good morning, my name is John McKelvey and I'm President of Midwest Research Institute in Kansas City. We are the third largest nonprofit research institute in the country and among our specialities are research into economics, energy, health, the environment, and other fields. Our clients range from private businesses of all sizes to the Federal Government.

One of our primary efforts is in the field of alternative energy sources. We operate the Solar Energy Research Institute for the Department of Energy and have a number of other active energy-related projects.

In announcing this hearing on tax incentives for exports, the Chairman of the Subcommittee on Taxation and Debt Management said that "the time has come to get serious about an export policy." He went on to note that "in light of the costs of energy imports, we cannot afford not to have a program to increase exports."

Based upon our review of America's trade position, as well as our energy situation, we believe that there is a direct relationship between the need to develop a trade policy that will stimulate exports and an energy policy that will reduce reliance on imported petroleum. The use of tax incentives, such as those contained in Senate Bills 700 and 1065 presently under consideration, would be an effective means for both improving our export position and stimulating private sector research and development aimed at reducing (and, ultimately, eliminating) our dependence on foreign oil through the commercialization of domestic alternative fuels.

Senate Bill S. 700 would amend the Internal Revenue Code of 1954 to provide a 10 percent tax credit for research and development (R. & D.) expenditures. In my opinion, that tax credit is needed to provide sufficient incentive for new R. & D. investment by American industry. That new investment can have a two-fold impact on our country's economy.

First, it can help offset our negative balance of trade by helping to increase in our exports. Second, it would provide additional funds for R. & D. activities, including those aimed at commercializing domestic alternative energy resources that would reduce our reliance on expensive imported oil. These two goals are, of course, closely related since the major portion of our balance of trade deficit, which is nearly $30 billion annually, directly stems from our increased (and, unfortunately, still increasing) importation of foreign petroleum.

In regard to our export position, it is generally recognized that one factor contributing to America's declining foreign trade position is the erosion of the technological advantage that American industry traditionally enjoyed over other countries. Another factor is the domestic slowdown in our productivity growth rate (i.e., the economic output per unit of labor force input).

I believe that these have resulted, in major part, from our failure to maintain a high level of commitment to R. & D. investment when compared to our major competitors. While America still leads the world in innovative technology, there are clear signs that point to our decline in this area.

Federal Government funds for R. & D. have not kept pace with inflation, and private spending has managed to stay only slightly ahead of inflation. Meanwhile, our competitors (especially West Germany and Japan) are devoting more of their resources to R. & D., and are obtaining more U.S. patents for their efforts. As a result, the U.S. is near the bottom of the industrialized nations in productivity growth with an annual rate of increase of about 2.3 percent (compared to 5.7 percent for West Germany, 4.2 for Japan, and 5 percent for France).

In addition, our productivity growth rate, which increased at an average of 3.4 percent a year in the 1960's, has dropped to 2.3 percent in the 1970's. Although other factors also came into play, those industries that showed high productivity growth rates were those that spent the most on R. & D. Thus, improvement of our trade position will depend, in large part, on the growth of American technology. And, in turn, such growth will depend on the ability of American business to invest in R. & D.

The relation between R. & D. activity by U.S. industry and export performance has been clearly shown. There is a direct correlation between an industry's investment in R. & D. (whether measured by the money invested, or the manpower resources—scientists and engineers—employed) and the amount of the world market occupied by that industry. A similar conclusion, in regard to the relationship between R. & D. activity and productivity growth, was reached by the National Center for Productivity and Quality of Working Life. The Center concluded that:

"Industrial R. & D. outlays tend to be positively correlated with productivity growth * * * the current slowdown in productivity growth rate is partially due to the declining rate of expenditures on R. & D."

There has been virtually no growth in R. & D. spending in the United States in the past 10 years. For example, National Science Foundation data establishes that R. & D. spending was 3 percent of our Gross National Product in 1964, only 2.2 percent of the GNP in 1977, and will fall to 2 percent by 1985. Futhermore, in terms of constant dollars, 1977 R. & D. outlays were actually 4 percent below 1967 spending levels.

In recent years, not only have other industrialized nations been increasing their R. & D. spending while ours has been declining, but these countries have been winning a greater share of the patents issued by the U.S. Patents granted to foreign interests increased 91 percent between 1966 and 1976. At present, 37 percent of all of all U.S. patents are being issued to foreigners. Of the 65,000 patent applications now pending, over 20,000 are from foreign sources.

One method for encouraging R. & D. activity would be to increase direct Federal spending. The Federal Government has been a major source of R. & D. spending, particulary in regard to basic research. At present, our colleges and universities (which are the primary resource for basic research) still depend on the Federal Government for two-thirds of their R. & D. budgets. Private spending by industry, while keeping slightly ahead of inflation, has nonetheless, fallen by 20 percent in the area of basic research—the long-term work that is the basis for future scientific and technological innovation.

However, direct Federal R. & D. spending, aside from that on basic research, has barely kept up with inflation since the late 1960's. In constant (1967) dollars, Federal spending in R. & D. was at $26.5 billion in 1967 (up from $13.6 billion in 1963). But is estimated to be only $13.8 billion in 1979. Although the Federal budget for fiscal year 1980 proposed expenditures of $30.6 billion (in current dollars) on R. & D., this amount is only $13.5 in constant (1967) dollars and would be a slight decline from the estimated 1979 level.

In light of these trends in direct Federal (and, in the case of basic research, private) spending for R. & D., alternative means for augmenting our investment in R. & D. must be considered. One such means would be the use of the proposed tax credits to encourage increased private spending on R. & D. The National Center for Productivity and Quality of Working Life has noted that: "Productivity growth has been achieved primarily as a result of private initiatives taken for private economic

gain. In our mixed and interdependent economy, however, few efforts are exclusively private; the government plays an important supportive role."

Passage of the tax credit legislation would be just such a "supportive role." Senate Bill 700 would encourage the private sector to increase R. & D. spending by providing a 10 percent tax credit for each dollar a business spends on R. & D. This tax treatment would, in effect, be the same as that now available for capital investment. S. 700 says that innovative ideas are as important as machinery.

Acceptance of that concept is essential to our future.

While Senate Bill 700 is primarily concerned with R. & D. intended to lead directly to the expansion of export markets for American business and industry, its companion legislation, Senate Bill 1065, would provide an incentive for "basic" research, which is conducted by our universities and colleges.

As noted before, private support for basic research has fallen by 20 percent. S. 1065 would provide a tax credit designated for basic research. The tax credit would equal 25 percent of the gift. Thus, a significant new source of funds would be made available for basic research, Furthermore, as the results of the research conducted with these corporate contributions would be available to the public, the fruits of such research can, and will, be brought to the marketplace as long as they prove to be economically feasible.

The incentives provided by S. 700 and S. 1065, which would augment direct Federal spending for R. & D., can lead to the desired improvement in the U.S. export position. In addition, these incentives would, of course, be available to industry, business—both large and small—and the academic community, to augment Federal spending specifically aimed at the development of (domestic) alternative energy resources.

Although Federal budget outlays for energy R. & D. have increased significantly since the Arab embargo, energy R. & D. programs and projects must compete with other government activities for support. As a result, many meritorious ideas (whether conceived by researchers at our universities, our large industries, our small businesses) cannot be supported, because of funding limitations or program priorities. Senate Bills 700 and 1065 could help remedy this situation.

It is worth noting that, with the Energy Tax Act of 1978, the Congress has taken a first step in providing energy-oriented tax incentives. Title I of the Act provides for tax credits to individual tax-payers who install insulation and other energy conserving items, as well as for the installation of various renewable (solar, wind, or geothermal) energy source equipment. Title III provides businesses with a tax energy credit for investments in certain types of energy property, including boilers and burners using fuels other than oil or natural gas; equipment to convert to synthetic fuels; and solar, wind, and geothermal equipment. However, these tax credits relate only to investment in equipment and materials. They do not extend to R. & D. activities aimed at developing domestic alternative energy resources. Senate Bills 700 and 1065 would provide such credits.

Also, the President has recently proposed, as part of his "Energy Security Fund" program, tax credits for certain energy activities. Specifically, the President's proposals call for tax credits for shale oil production; for agricultural and industrial solar equipment, for presidential wood stoves, and for passive solar systems. Again, the tax credit impact would be in the area of investment in equipment and materials, rather than for energy R. & D.

In conclusion, based on our analysis of Senate Bills 700 and 1065, I believe that the proposed legislation would not only provide a general incentive to increase R. & D. spending, with its attendant positive impact on our world export position but, equally as important, would provide a specific incentive for R. & D. aimed at developing domestic alternative energy resources, thereby reducing our dependence on imported petroleum, and further improving our balance of trade.

Senator BYRD. Mr. Hilly?

STATEMENT OF CHARLES F. HILLY, VICE PRESIDENT FOR GOVERNMENT RELATIONS, SRI INTERNATIONAL

Mr. HILLY. Mr. Chairman, members of the committee, I am Charles Hilly and I am vice president, government relations, of SRI International, which was formerly Stanford Research Institute. By way of introduction, our organization is a public service, nonprofit organization established in 1946 to provide basic and applied re-

search services to governments and businesses throughout the world.

Our principal laboratories and research facilities are located in Menlo Park, Calif., our headquarters, but we do maintain other offices throughout the United States and abroad.

We believe we are well qualified to speak to matters of research and development because of our substantial involvement in this field. Last year, we received approximately $120 million in research contracts and this year our current volume is about $135 million.

SRI appreciates the opportunity to present information concerning S. 1065 amending the Internal Revenue Code of 1954 to provide an income tax credit to corporations for contributions for basic research.

Over the past 30 years, SRI International has been performing basic research services for business and government. Our close association with these sectors in seeking technological solutions to today's problems makes us well aware that there has been a substantial drain on the storehouses of basic knowledge. Revitalizing this foundation is essential so that the United States can continue to develop new products and innovative processes to keep secure its technological edge.

Demands upon the Federal Government's budget have necessitated concentration upon current problems, concentrating on applied research rather than basic research.

Simultaneously, on the commercial front, the competitive forces of the marketplace have required business and industry to invest their resources in low-investment projects with shorter-range return. As a result, long-range basic research has been sadly neglected to the point that we are now losing our place at the forefront of technology in world competition.

To illustrate these points, our paper contains relevant facts about ourselves and our industrial competitors, Germany and Japan. These have been cited several times today and I will skip over those.

We feel that these danger signals cited in these statistics evidence the need for stimulating investment in the basic research sciences. We therefore endorse congressional action to amend the Internal Revenue Code of 1954 to provide an income tax credit to corporations for contributions for basic research.

We note, however, that the legislation as presently proposed allows the tax credit to support basic research only at educational institutions as defined under section 170 of the Internal Revenue Code. In 1978, these institutions performed 52 percent of the $6.05 billion allocated for basic research, private industry performed 16 percent, the Federal Government and federally funded research and development centers performed 23 percent, and other not-for-profit organizations accounted for 9 percent.

If the fundamental purpose of this legislation is to encourage increased spending for basic research, SRI International believes that this should be done across a broader front including all not-for-profit organizations whose primary purpose is the advancement of scientific knowledge.

This would broaden the resource base and thereby foster competition among the recipients of the funds of this new tax incentive.

Accordingly, SRI encourages this committee to consider expanding the application of this proposed legislation by providing a tax credit to corporations which allocate basic research funds to any scientific or educational organization qualifying under section 501(c)(3), in lieu of organizations as outlined in section 170 of the Internal Revenue Code.

We appreciate the opportunity to appear before your committee to present information with respect to this legislation. If SRI International may be of further assistance to you, we would welcome the opportunity to do so.

Thank you.

Senator DANFORTH. Mr. Seghers?

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INTERNATIONAL TAX INSTITUTE, INC.

Mr. SEGHERS. We thank the committee for this opportunity to present our views. You are to be complimented for your statesmanlike decision to examine proposals for tax incentives for U.S. exports.

We hope that Congress will act to provide such incentives.

Our statement will be very brief. It will state some truths that Congress should recognize.

The International Tax Institute was organized in 1961 when the threat of Stanley Surrey to foreign trade was perceived.

The first and most harmful blow was the enactment in 1961 of the tax on imaginary dividends from foreign corporations.

Ever since then, both the Treasury and Congress have added tax burdens on income of U.S. manufacturers from the sale of their products to buyers abroad.

Smaller U.S. manufacturers are deterred from entering the risky and difficult business of selling their products in world markets. This is the result of the hostile attitude of Congress, the Treasury, and the big union bosses toward foreign trade.

The uncertainty and fear of additional taxes and handicaps result in a reluctance to embark on the risky and difficult task of marketing their products abroad. Profit rather than loss from foreign trade can be hoped for only if the manufacturer engages actively in marketing abroad and is able to compete successfully with European and Japanese manufacturers who are helped rather than hindered by their governments in that competition.

If the Congress wishes to encourage smaller U.S. manufacturers to export their products, it should enact tax provisions that afford incentives, and repeal those that unfairly handicap U.S. manufacturers in selling their products in the world market.

Congress should restore the DISC provisions in their original form with a few clarifications.

Congress should repeal the tax on imaginary dividends from foreign subsidiaries—repeal what is known as subpart F—section 951 et seq. of the Internal Revenue Code.

No other country imposes such a tax. Repeal of subpart F would not violate the letter or the spirit of GATT. That is not a tax on

U.S. income—it is a tax on income earned and retained abroad by foreign corporations.

When brought home, it is fully taxed. Ample evidence has been presented by both tax committees of Congress that show that U.S. manufacturers have brought home far more income from their foreign subsidiaries than they have sent abroad for investment.

Give them a chance to earn more and they will bring more income home.

VAT would afford another incentive for exports. If Congress does not know and understand this, it should learn.

Congress needs to exercise more control over the Treasury's attempt to collect more taxes by legislation in the form of regulations.

When I speak of tax incentives for smaller U.S. manufacturers to engage in export and marketing their products abroad, I speak from experience and intimate knowledge in this field, as well as from a burning conviction that this would be for the good of all our people.

We hope that Congress will carefully consider and act—not just orate—to encourage U.S. exports and foreign trade.

I have made some statements. If they are true, Congress should act. If they are not true, I would like to hear a question or objection.

Senator DANFORTH. Thank you all very much.

Mr. Hilly, with respect to your comments on contributions to nonprofit organizations other than colleges and universities, I think that is an excellent suggestion and it will be one that will receive very careful consideration. I appreciate it.

Just one point. The time is late. I am sorry that more members of the committee were not here to hear these presentations, but I know MRI, and one thing that is interesting about it is the kind of support that this organization gets in its community, and I think that you will agree with me, John, that it is something of a major source of pride for Kansas City. Some of the leading citizens of Kansas City participate on your board of directors.

It seems to me that one thing that is involved in this entire concept is the hope of the American people, the mood, the public attitude.

There is nothing more dismal than when people lose hope in the future, when they think that there is nothing more in it for them, that we are just going to hunker down, and shrink; that government will assume a larger and larger role in dividing up the diminishing assets and resources that we have.

What people really believe in is the ability that we have as a country to develop new technology and to use our know-how and the kind of spirit that that belief generates.

I was wondering if you might have some comment about whether this is a correct analysis on my part.

There is a tremendous potential here, not only to do something to reverse the trade deficit, or to develop new sources of energy, but also to provide a really positive sense on the part of the people of our country that we are heading somewhere; that we have a future.

Mr. MCKELVEY. I will make a brief comment on that.

You mentioned the interest of the local community and the business leaders in MRI. One of the reasons that I came here to testify was the strong encouragement I received from my executive committee to come to Washington and let the Senators know that MRI as an institution was interested in, and Kansas City business leaders were also equally behind these two measures.

I think the kind of legislation you are discussing does impact upon the people and it does give them the kind of encouragement that we need to have.

Senator DANFORTH. Are there any other comments?

Mr. HILLY. I would like to comment.

I think this is a proper approach. I think earlier today one of the speakers commented on increasing Federal expenditures to supplement the basic research activities going on.

I believe that the approach that this tax bill is taking, making that money available for industry through basic research organizations to take up the things which are apparent in that sector need to be done, rather than more Federal R. & D. management, I think it would be much more productive for the dollars invested.

Mr. SEGHERS. One of the earlier witnesses gave a splendid talk about the necessity of acquainting executives of the smaller manufacturers with the benefits of DISC. They would be even more influenced if we did away with this tax on imaginary dividends, subpart (F), and I think if you take off some of the burdens on exports and on foreign trade—remember that the largest U.S. manufacturers that have the most plants producing goods abroad are increasing their exports at a greater rate than those companies who do not have foreign manufacturing plants.

Another thing to remember is that the foreign branches that could be engaged in selling goods and efficiently distributing them are penalized under this subpart (F). You cannot maintain a stock of goods in Belgium, for example, and distribute it in a nearby country without immediately invoking this provision, the taxes and imaginary dividends measured by the income realized that way.

If you have a separate corporation in each country, you are not penalized by subpart (F). That is a very distinct handicap to the smaller manufacturer, when a smaller manufacturer could maintain a warehouse in Panama and distribute in South America goods that could be flown by air and there was a very efficient air service, more efficient than right here in New York, quicker loading and better facilities for getting goods down to South America if they were not too heavy—and even in some cases where there were emergencies, they would ship pretty heavy machinery.

That was spoiled. A delegation came up from Panama to argue against subpart (F) and they did not say anything. They went back with some promises of financial aid to Panama.

Senator DANFORTH. Thank you very much.

[The following material was subsequently supplied for the record:]

U. S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C., June 15, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: It has come to my attention on June 18th, your subcommittee is conducting hearings on several bills principally concerned with capital recovery, depreciation, investment credit, and other proposals to strengthen the ability of U.S. concerns to expand their export efforts.

As you may be aware, I have offered legislation in the very same areas, including S. 110 in depreciation for small business, S. 487, S. 653 and further bills to be introduced in the very near future.

I would therefore hope and request that my bills be scheduled for hearings, and be described and analyzed by the Joint Tax Committee in a manner similar to bills coming up for the present session.

With best wishes,

Sincerely,

GAYLORD NELSON, *Chairman.*

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., July 16, 1979.

Hon. HARRY F. BYRD, Jr.,
U. S. Senate, Washington, D.C.

DEAR SENATOR BYRD: On June 20, 1979, you requested that the staff of the Joint Committee on Taxation prepare descriptions of three bills—S. 110, S. 487 and S. 653—for inclusion in the record of the June 18, 1979, hearings of the Subcommittee on Taxation and Debt Management Generally.

Pursuant to your request, I am enclosing descriptions of these bills. These explanations generally follow the form of the staff descriptions of bills contained in the pamphlet prepared for the June 18, 1979, hearings.

Sincerely yours,

BERNARD M. SHAPIRO.

Enclosures.

S. 110—SENATOR NELSON

SPECIAL DEPRECIATION FOR CERTAIN PROPERTY

A. *Summary*

The bill would permit a taxpayer to elect to depreciate up to $25,000 in annual acquisitions of property over a 3-year period under the straight-line method of depreciation and to obtain the benefit of the full investment tax credit (based on the regular useful life of the property) with respect to property for which an election has been made.

The bill would apply to property placed in service in taxable years ending after the date of enactment.

B. *Present law and issues*

Present law.—If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence, the adjusted basis (less salvage value in excess of 10-percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use. This approach to the recovery of the cost of an asset is referred to as depreciation.

In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, 5-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for

certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

Issues.—The major issues raised by the bill are whether taxpayers should be able to elect to use rapid depreciation for a limited amount of tangible personal property and whether, if such depreciation is elected, taxpayers could continue to use the regular useful life of the property for which an election is made for purposes of determining the investment credit.

C. *Description of the bill*

Explanation of provisions.—The bill would permit a taxpayer to elect to depreciate up to $25,000 in annual acquisitions of property [1] over a 3-year period under the straight-line method of depreciation and to obtain the benefit of the full investment tax credit (based on the regular useful life of the property) with respect to property for which an election has been made. Property which is depreciated under this provision is not eligible for additional first-year depreciation under section 179 (but no other changes are made with respect to section 179).

Effective date.—The bill would apply to property placed in service in taxable years ending after the date of enactment.

Revenue effect.—Assuming that the bill would be amended to exclude real property, it is estimated that the bill would increase tax liabilities by $100 million in calendar year 1980 and would reduce tax liabilities by $1.4 billion in calendar year 1981, by $3.3 billion in calendar year 1982, by $4 billion in calendar year 1983, and by $3.3 billion in calendar year 1984.

Other issues for committee consideration

The committee may wish to consider a number of other issues which relate to this new depreciation proposal. Most of these issues are relatively technical, and solutions to the problems raised may well be achievable without jeopardizing the basic policy goals of the proposal. One issue is whether controlled group and related party rules need to be adopted for purposes of preventing avoidance of the dollar limitation on eligible assets. Another issue is how these provisions are to be coordinated with other rules such as the minimum tax and the recapture rules. Still another issue is what conventions (half-year, modified half-year, etc.) should be allowed, or required, in connection with this proposal. An additional issue is whether these useful lives would (or should) apply to leased property. Also, it is not clear whether the dollar limitation on eligible assets applies at the partner level or the partnership level.

S. 487—Senators Nelson, Stewart, and Packwood

CREDIT FOR INVESTMENT IN ORIGINAL ISSUE STOCK OF SMALL BUSINESSES

A. *Summary*

The bill would provide a nonrefunadable credit against the income tax liability of a citizen or resident of the United States who invests in incentive stock of certain small businesses. The credit would be equal to 10 percent of the first $10,000 of the taxpayer's investment in such stock acquired for money during the taxable year, plus 5 percent of any investment in excess of $10,000. The maximum credit allowed to an individual in a taxable year would be $3,000 ($6,000 in the case of a married individual filing a joint return). Estates and trusts would not be eligible for the credit.

To be eligible for the credit, an individual would have to acquire qualifying incentive stock for money within 180 days of the date of issue. In addition, the individual would ordinarily have to continue to hold the stock on the due date of the return for which the credit is claimed, and the credit would (under most circumstances) be recaptured if the stock is disposed of (other than by gift or bequest) within 6 months of the date of acquisition.

The provisions of the bill generally would apply to taxable years beginning after December 31, 1979, and to stock acquired after the date of enactment.

B. *Present law and issue*

Present law.—Under present law, credits against a taxpayer's income tax liability are provided for certain investments. Credits are allowed, within certain limits, for investment in depreciable business assets (secs. 38 and 46), for contributions to ESOP's based on the investment in depreciable business assets (sec. 46), and for

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[1] Although it appears that these special depreciation rules are intended to be applicable only to tangible personal property, the bill by its terms would apply to any property (including real property) which is eligible for depreciation under section 167 of the Code.

qualified energy expenditures (sec. 44C). No credit is allowed for investment in stock of a corporation.

Issue.—The issue is whether a credit against income tax liability should be allowed to individuals who invest in original issue stock of certain small businesses.

C. *Description of the bill*

Explanation of provisions.—The bill would provide a nonrefundable credit against the income tax liability of a citizen or resident of the United States who invests in incentive stock of certain small businesses. The credit would be equal to 10 percent of the first $10,000 of the taxpayer's investment in such stock acquired for money during the taxable year, plus 5 percent of any investment in excess of $10,000. A taxpayer's investment in incentive stock would be his adjusted basis in such stock. The maximum credit allowed to an individual in a taxable year would be $3,000 ($6,000 in the case of a married individual filing a joint return). Estates and trusts would not be eligible for the credit.

Under the bill, incentive stock means original issue common or preferred stock which is registered under the Securities Exchange Act of 1934 and offered to the public in an unrestricted offering. The aggregate selling price of the stock offered in such an offering could not exceed $7,500,000. The incentive stock would have to be issued by a domestic corporation (other than a subchapter S corporation) having equity captial of $25 million or less. In addition, the bill would place limitations on the amount of passive income of a qualifying issuing corporation.

The credit would not be allowed to an individual who controls at least 80 percent of the issuing corporation or to an individual who is claimed as a dependent by another taxpayer. Also, the credit would not be allowed for the acquisition of incentive stock by an underwriter in the ordinary course of the underwriter's trade or business.

To be eligible for the credit, an individual would have to acquire qualifying incentive stock for money within 180 days of the date of issue. In addition, the individual would be subject to certain holding requirements with respect to the stock. The individual would have to hold the incentive stock on the date for filing his tax return for the taxable year of the acquisition. If the taxpayer claimed a credit for incentive stock for a preceding taxable year and failed to hold the stock for more than six months, his tax for the year of disposition would be increased by the amount of the credit.[1]

The limitations with respect to the holding period of incentive stock would not generally apply in the case of a bequest or gift unless the bequest or gift were a deductible charitable donation or the recipient disposed of the stock before it was held for more than 6 months (including any period held by the decedent or donor).

The credit would generally be applicable against an individual's income tax liability. The credit could not be applied, however, against (1) the minimum tax on tax preference items (sec. 56), (2) the 10-percent tax on premature distributions to owner-employees (sec. 72(m)(5)(B)), (3) the tax on lump sum distributions (sec. 402(e)), (4) the additonal tax on certain distributions from IRAs (sec. 408(f)), (5) the tax on accumulated earnings (sec. 531), (6) the tax on personal holding companies (sec. 541), (7) the tax on certain capital gains of subchapter S corporations (sec. 1378), or (8) the additional tax on account of recoveries of foreign expropriation losses (sec. 1351(d)(1)).

Effective date.—The amendments made by the bill would apply to taxable years beginning after December 31, 1979, and to stock acquired after the date of enactment. Stock acquired after the date of enactment, but before December 31, 1979, would be treated as if it were acquired on the first day of the first taxable year of the taxpayer beginning after December 31, 1979, except for purposes of the rules relating to the time of acquisition and the holding period of such stock.

Revenue effect.—It is estimated that this bill would reduce income tax liabilities by $25 million per year for calendar years 1980 through 1984.

Other issues for committee consideration

The committee may also wish to consider certain other issues arising in connection with this bill. For example, the bill provides that a tax credit is available for certain investments in small businesses which are defined as corporations in which the equity capital is $25 million or less. This test would appear to apply the tax credit to stock in many companies listed on the American Stock Exchange. The committee may wish to consider whether this equity capital limitation is an appropriate test to define small business for purposes of this bill.

Also some unusual results appear to arise because of the interplay of the recapture rule, which is inoperative if stock is held more than 6 months, and the rule

[1] There appear to be some technical problems with the "holding" and recapture provisions.

that generally requires that, for the credit to be allowable, the stock be held on the due date of the return for the year the stock is purchased. The effect of these rules is to require a 15½-month holding period in some cases (qualifying incentive stock acquired in early January or a calendar year taxpayer) and a 6-month holding period in other cases (stock acquired after October 15 for a calendar year taxpayer).

S. 653—SENATORS NELSON, BAUCUS, WEICKER, AND HUDDLESTON

NONRECOGNITION OF GAIN ON THE SALE OF CERTAIN SMALL BUSINESS STOCK

A. *Summary*

The bill would provide for the elective nonrecognition of an individual's gain from the sale or exchange of certain small business stock if the proceeds were reinvested in other small business stock within 18 months of the sale. If an election is made, gain on the sale of such stock would be recognized only to the extent that the sale price exceeds the cost of the small business stock purchased during the 18 months following the sale. If a taxpayer makes the nonrecognition election, the basis of the small business stock acquired during the 18-month period would be reduced by an amount equal to the unrecognized gain realized on the sale.

The provisions of the bill would apply to stock acquired after the date of enactment.

B. *Present law and issues*

Present law.—Present law generally requires recognition of the entire amount of gain or loss realized on the sale or exchange of property (sec. 1001(c)). However, in a number of instances, the Code provides for the nonrecognition of gain or loss, e.g., section 351 (relating to transfers to corporations controlled by the transferor), section 354 (relating to exchange in certain reorganizations), section 721 (relating to certain partnership contributions), section 1031 (relating to certain exchanges of business or investment property), section 1033 (relating to certain involuntary conversions), section 1034 (relating to certain residential sales or exchanges), and section 1039 (relating to certain sales of low-income housing projects). Generally, none of these nonrecognition provisions would apply to gain realized on the sale of small business stock.

Issue.—The issue is whether nonrecognition of gain should be allowed where the proceeds of the sale or exchange of certain small business stock are reinvested in other qualifying small business stock.

C. *Description of the bill*

Explanation of provisions.—The bill would provide for the elective nonrecognition of an individual's long-term capital gain from the sale or exchange of certain small business stock if the proceeds are reinvested in another small business stock within 18 months of the sale. Under the bill, gain would be recognized to the extent that the sale price exceeds the cost of the small business stock purchased during the 18 months following the sale. If a taxpayer makes the nonrecognition election, the basis of the small business stock acquired during the 18-month period would be reduced by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, both the interest sold and the interest subsequently acquired would have to qualify as "small business stock." Under the bill, "small business stock" means common or preferred stock issued by a domestic corporation or small business investment company (other than a subchapter S corporation), which has equity capital of $25 million or less. In addition, the bill would place limitations on the amount of passive income of a qualifying corporation.

The nonrecognition election would not be available to an underwriter who acquires small business stock in the ordinary course of his trade or business as an underwriter.

Gain or loss on small business stock, the acquisition of which resulted in the nonrecognition of gain from the sale of other small business stock, would be treated as long-term capital gain or loss because the holding period of such stock would include the holding period of the stock previously sold.

The bill would provide that the statutory period for the assessment of any deficiency would not expire until three years after the date that the taxpayer notifies the Secretary of the Treasury of (1) the cost of purchasing the small business stock which the taxpayer claims results in nonrecognition of gain, or (2) the intent not to purchase or the failure to purchase other qualifying small business stock within the specified time.

Effective date.—The amendments made by the bill would apply with respect to stock acquired after the date of enactment.

Revenue effect.—It is estimated that this bill would reduce income tax liabilities by $700 million in calendar year 1980, by $770 million in calendar year 1981, and by $1.025 billion in calendar year 1984.

Other issues for committee consideration

The committee may also wish to consider certain other issues arising in connection with this bill. For example, the bill applies elective nonrecognition treatment to "small business stock" which is defined as stock in an enterprise the equity capital of which is $25 million or less. This test would appear to apply the elective nonrecognition treatment to stock in many companies listed on the American Stock Exchange. The committee may wish to consider whether this equity capital limitation is an appropriate test to define eligible small businesses for purposes of this bill.

Also, in most circumstances where the taxpayer is given an election as to the tax treatment of a transaction, the time and the manner in which the election is to be made is either specified in the provisions or the Secretary of the Treasury is given the authority to prescribe rules as to the time and manner of making such an election. Since this bill does not prescribe such rules or grant the Secretary this authority, it appears that the election could be made at anytime (including after the commencement of an audit). The committee may wish to consider whether it is appropriate to provide rules as to the time and manner in which such an election is to be made or to give the Secretary the authority to provide such rules.

In addition, it is not clear who is to make a nonrecognition election in the case of gains realized by pass-through entities, such as partnerships, Subchapter S corporations, or regulated investment companies.

INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on June 18, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a discussion of each bill, setting forth present law, the issues involved, an explanation of the bill provisions, the effective dates, and the estimated revenue effects. Appendix tables present certain information concerning trends in U.S. export trade.[1]

The bills described in the pamphlet are S. 231 and S. 935 [2] (relating to depreciation), S. 700 (relating to the investment tax credit for certain research and experimental expenditures), S. 1003 (relating to bad debt reserves for export receivables, and to the treatment of research and experimental expenditures and foreign currency losses on export receivables), and S. 1065 (relating to corporate charitable contributions for basic research).

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[1] The Appendix tables were supplied by the staff of the Senate Finance Committee.

[2] The bill, S. 935, was not listed in the press release announcing the hearing, but was subsequently scheduled for this hearing and included in the notice of hearings printed in the Congressional Record on May 24, 1979.

I. SUMMARY OF BILLS

S. 231—Senator Bentsen

The bill would increase the asset depreciation range under the Asset Depreciation Range (ADR) system from 40 percent (i.e., 20 percent above or below the ADR class lives) to 60 percent (30 percent above or below the ADR class lives) and would provide that salvage value could be ignored under the ADR system of depreciation.

The bill also would provide that certain small businesses may elect to use an abbreviated table of useful lives which are shorter than the useful lives other businesses may use. These shorter useful lives could be used only in connection with the straight-line method of depreciation.

S. 935—Senator Chafee

The bill would allow taxpayers to elect to depreciate tangible personal property (and certain other tangible property eligible for the investment credit) over a period of not less than 5 years. The bill also would shorten the period over which the amortizable basis of pollution control facilities can be amortized from 60 months to 24 months and would provide that the excess of this amortization deduction over the depreciation deduction otherwise allowable would no longer be a tax preference item.

S. 700—Senator Danforth

Present law generally provides a credit against income tax liability equal to 10 percent of the investment in certain business assets. Research and experimental expenditures which are currently deductible (or which, at the taxpayer's election, are capitalized and amortized) are not treated as being for qualifying property for purposes of this investment credit. The bill would make the investment credit available for these research and experimental expenditures, effective for expenditures incurred in taxable years beginning after December 31, 1979.

S. 1003—Senators Bentsen and Danforth

The bill contains three separate provisions that would provide additional deductions to certain taxpayers engaged in export operations and in the development of foreign markets and foreign patents. The first provision would allow the taxpayer to take a bad debt deduction for accounts receivable which arise from the sale of export property or services for use outside the United States, equal to the greater of 2 percent of these accounts receivable or 15 percent of the taxable income derived from these export operations. The second provision

would allow the taxpayer to elect to treat certain amounts paid to develop export markets and export products as research and experimental expenditures and, thus, deductible in the year paid or accrued or amortizable over a 60-month period. The third provision would allow the taxpayer to elect, on a currency-by-currency basis, to deduct foreign currency losses on export receivables in the current year rather than in the year the receivable is paid.

S. 1065—Senators Danforth, Javits, and Moynihan

The bill generally would provide corporate taxpayers with a nonrefundable credit against Federal income tax liability for charitable contributions paid in cash during the taxable year to qualified educational organizations, if as a condition of the gift the donee must use the contribution exclusively for scientific basic research. The amount of the credit would be 25 percent of the qualified basic research contributions, adjusted according to a formula. The credit would generally apply to increases in the level of contributions made for basic scientific research. The formula is designed so that the amount eligible for the credit would be reduced if the gifts normally given to charitable organizations for other purposes were reduced. The provisions of the bill would apply to taxable years beginning after December 31, 1979.

II. CERTAIN BILLS RELATING TO DEPRECIATION

S. 231

EXPANSION OF THE ASSET DEPRECIATION RANGE (ADR) VARIANCE FROM 20 PERCENT TO 30 PERCENT AND TO PROVIDE A SIMPLIFIED TABLE FOR FASTER DEPRECIATION FOR SMALL BUSINESS

and

S. 935

CAPITAL COST RECOVERY ACT OF 1979

A. Present Law and Issues

Present law

Depreciation in general

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, decay or decline from natural causes, exhaustion and obsolescence,[1] the adjusted basis (less salvage value in excess of 10 percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use.[2] This approach to the recovery of the basis of an asset is referred to as depreciation.

For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method, the sum-of-the-years-digits method, or any other method used consistently by the taxpayer which does not result in the allowance of greater aggregate depreciation deductions during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method (e.g., methods based on units of production, machine time, etc.). These accelerated methods are not allowed for intangible assets. Administrative practice

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[1] If the asset is not subject to these factors, depreciation is not allowable. For example, land is not depreciable.

[2] In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

has permitted the 150-percent declining balance method to be used for used tangible personal property. (Rev. Rul. 57-352, 1957-2 C.B. 150; Rev. Rul. 59-389, 1959-2 C.B. 89.)

The key factors which determine the amount and the timing of depreciation deductions with respect to any depreciable asset are: (1) the cost of the asset; (2) the salvage value of the asset; (3) the useful life assigned to the asset; and (4) the method of depreciation (e.g., straight line or an accelerated method). Since determinations of the first three of these factors are essentially factual and are based on circumstances which may be unique to the taxpayer's situation, many controversies arise between taxpayers and the Internal Revenue Service on appropriate useful lives and salvage values. Thus, a major purpose for establishing the ADR system was to reduce the controversies relating to useful lives and salvage values for certain types of property. Similarly, a repair allowance system was provided to reduce controversies over the classification of expenditures as currently deductible repairs or as capital improvements.

ADR System

In general

The regular rules relating to allowable methods of depreciation generally are applicable under the ADR system. However, in the case of new tangible personal property with a useful life of three years or more, a taxpayer who elects ADR may only select the straight-line, 200-percent declining balance (up to 200 percent), or sum-of-the-years-digit methods. For used depreciable personal property, accelerated depreciation is limited to the 150-percent declining balance method, i.e., 150 percent of the straight-line rate.

Election

A taxpayer must make an irrevocable election to apply the provisions of the ADR system to eligible property placed in service during the taxable year. This election is applicable to all eligible assets placed in service during the taxable year and is effective as to those assets for all subsequent taxable years. This election must be made on Form 4832 and filed with the taxpayer's income tax return for each year that application of the ADR system is elected. If, in a subsequent taxable year, the taxpayer does not elect to apply the ADR system, the regular rules regarding depreciation will be applicable to any depreciable assets placed in service during that taxable year. A valid election to apply the ADR provisions must contain the taxpayer's consent to comply with all of the ADR requirements and must specify certain information (for example, the asset guideline class and the first-year convention adopted by the taxpayer for the taxable year of election). In addition, the taxpayer must maintain books and records from which certain specific information can be drawn (for example, the depreciation period and salvage value for each vintage account established for the taxable year and each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance). Also,

taxpayers who elect the ADR provisions must respond to infrequent data surveys conducted by the Treasury Department.[3]

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable property for which an asset guideline class and an asset guideline period have been prescribed by the Treasury Department for the taxable year of election. If used property constitutes a significant portion of the property placed in service during a taxable year (10 percent), a taxpayer may elect to apply the ADR system only to new property.

Presently, with certain very limited exceptions, the ADR system does not apply to depreciable real property. Until class lives under the ADR system are prescribed for real estate, a taxpayer who has elected the ADR system may elect to determine the useful life of depreciable real property under Revenue Procedure 62-21 (which reflects the prior general IRS position on useful lives) as in effect on December 31, 1970, or on the basis of the facts and circumstances of the particular case.[4]

Vintage accounts

Under the ADR system, the allowance for depreciation is computed on the adjusted basis of the assets grouped together in a vintage account. The vintage of the account refers to the taxable year during which the eligible property is first placed in service. Each eligible property may be placed in a separate vintage account or, under certain circumstances, assets in the same guideline class may be placed in the same vintage account. However, new and used eligible property may not be combined in a single vintage account. Certain other property also may not be combined in a single vintage account, e.g., property eligible for additional first-year depreciation may not be combined with ineligible property.

Certain special rules have been provided to account for ordinary and extraordinary retirement of assets in a vintage account. Likewise, special rules are provided in connection with the recognition of gain or loss on retirements.

Useful lives and asset guidelines class

In general, the estimated useful life of assets in each asset guideline class is established by the Office of Industrial Economics of the Treasury Department. Each asset guideline class consists of a category of assets that have certain common characteristics or that are utilized in the same or related activities. Generally, a class life is established to reflect the actual asset replacement practices being employed by taxpayers and other factors, such as obsolescence. The taxpayer may use a depreciation life within a range (asset depreciation range) of 20 percent below or above the predetermined life of the asset guideline class.

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[3] The information reporting requirements for an electing taxpayer were reduced and simplified by the Treasury Department on January 26, 1979 (Treas. Reg. § 1.167(a)-11, as amended by T.D. 7593, 44 Fed. Reg. 5419). In general, much of the information which was required on IRS form 4832 is no longer automatically required to be submitted. Instead, the books and records of the taxpayer must be maintained so that such information is readily available, and if the Treasury Department surveys the taxpayer, the information called for must be submitted on the survey request.

[4] Section 5 of Public Law 93-625.

For example, if the asset guideline period for a certain asset guideline class is 10 years, the taxpayer may elect a useful life with respect to assets in that guideline class that is not less than 8 years (20 percent below the asset guideline period) nor more than 12 years (20 percent above the asset guideline period).

"Half-year convention" rules

Under the ADR system, two alternative conventions are provided for purposes of determining depreciation for the year during which property is first placed in service. First, the "modified half-year convention" provides that depreciation for a full year is allowed for all eligible property placed in service during the first half of the taxable year. All other eligible property will be treated as being placed in service on the first day of the next taxable year. Second, the "half-year convention" provides that depreciation is allowable for a half year for all eligible property placed in service during the taxable year. The same convention must be used for all vintage accounts of the same taxable year but may be changed as to vintage accounts of subsequent taxable years.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain. Thus, if salvage value is less than 10 percent, it may be ignored. The salvage value of each vintage account must be estimated by the taxpayer at the time of electing the ADR system for assets placed in service for a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

Treatment of repairs, maintenance, etc.

Under present law, the characterization of certain expenditures for the repair, maintenance, rehabilitation or improvement of property is a factual determination. If these expenditures substantially prolong the life of an asset or are made to increase its value or adapt it to another use, the expenditures are capital in nature and are recoverable in the same manner as the cost of a capital asset. All other expenditures for repair, maintenance, etc., are allowed as a deduction during the taxable year in which paid or incurred.

If a taxpayer elects to apply the ADR provisions, the taxpayer may make a further election to apply the provisions of the asset guideline class "repair allowance." Under these provisions, a taxpayer is allowed a current deduction for amounts paid or incurred for certain repairs, maintenance and similar expenditures to the extent that the expenditures do not exceed, in general, the average unadjusted basis of all repair allowance property multiplied by the repair allowance percentage. "Repair allowance property" is eligible property in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The repair allowance percentage is a predetermined rate established for each asset guideline class. Property improvements (including the amount of repairs, maintenance, etc., in excess of the

asset repair allowance) and excluded additions are capitalized in a special basis vintage account, subject to the ADR rules. If a taxpayer does not elect to use the asset guideline class repair allowance for assets in an asset guideline class, the regular rules regarding the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of property are applicable. If the repair allowance is elected, the taxpayer must maintain books and records to identify repair expenditures relating to specific classes of property, to allocate to specific classes of property the expenditures relating to properties in two or more classes, and to identify expenditures for excluded additions, e.g., expenditures which are clearly for capital items.

Recognition of gain or loss on retirement

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. Thus, under normal tax rules, each retirement of depreciable personal property (coupled with a sale, exchange, or abandonment) would result in current recognition of gain or loss.

Under the ADR system, recognition of gain or loss may be postponed for "ordinary retirements" of assets included in a vintage account, i.e., retirements occurring for routine causes during the range of years selected for the account. In this case, the proceeds from the retirement are added to the depreciation reserve of the vintage account. However, in the case of an "extraordinary retirement," any gain or loss resulting from the retirement is recognized. (The characterization of gain or loss is governed by the normal rules relating to depreciation recapture and gain or loss on property used in a trade or business (secs. 1231 and 1245).) For this purpose, an extraordinary retirement would include a retirement attributable to an insured casualty.

Depreciation for small business

Under present law, there are no special provisions pertaining to the depreciation of assets by a small business. Thus, a small business may depreciate its assets on a facts and circumstances basis or make an election to apply the ADR system. The same depreciation methods are allowable for small business as are allowable for other taxpayers.

Although not limited to small businesses, the provision for additional first-year depreciation (sec. 179) was enacted to provide a special incentive for small businesses to make investments in depreciable property. Under this provision, an owner of tangible personal property with a useful life of 6 years or more is eligible to elect, for the first year the property is subject to depreciation, a deduction for additional first-year depreciation in an amount not exceeding 20 percent of the cost of the property. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).[5] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Amortization of pollution control facilities

In general, if expenditures for pollution control take the form of a separate plant or equipment with a useful life in excess of one year, the

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[5] In the case of depreciable property owned by a partnership, the $10,000 limitation is applied at both the partnership level and the partner level.

expenditures must be capitalized and depreciated over its useful life. Also, an investment credit is normally available for such expenditures pursuant to the normal property qualification and useful life rules.

A taxpayer may elect to amortize the amortizable basis of any certified pollution control facility over a period of 60 months (sec. 169). In general, the term "certified pollution control facility" means a new identifiable treatment facility which is used, in connection with a plant or other property in operation before January 1, 1976, to abate, control or prevent water or atmospheric pollution or contamination and which is certified by State and Federal authorities. To qualify, the facility also must not significantly increase the output or capacity, extend the useful life, or reduce the total operating cost of the plant or other property or alter the nature of the manufacturing or production process or facility. Special rules are provided for situations where the facility has a useful life in excess of 15 years (sec. 169(f)(2)). Under section 169, the amortizable basis of a pollution control facility which is eligible for 60-month amortization is only that portion of the basis which is attributable to the first 15 years of the asset's useful life. Any remaining basis would be depreciated under the normal depreciation rules.

In addition, taxpayers may be able to finance all or a portion of the cost of providing air or water pollution control facilities with industrial development bonds, the interest from which is exempt from Federal income taxation (sec. 103(b)(4)(F)).

If both (1) five year amortization is elected, and (2) tax-exempt financing is utilized, the normal investment credit will be reduced by 50 percent to the extent the property is financed by the proceeds of an applies only with respect to the portion of the basis of property which is eligible for 60-month amortization.

Among the items which are tax preferences (subject to the "add-on" minimum tax) is the amount by which the amortization deduction for certified pollution control facilities under section 169 exceeds the depreciation deduction which would otherwise be allowable under section 167 (sec. 57(a)(4)).[6]

Issues

The bills (S. 231 and S. 935) raise four major issues. The first issue is whether it is appropriate to provide for acceleration of depreciation deductions to a degree greater than that provided under existing law as an incentive for exports and as a method of increasing productivity. If it is desirable to provide for greater acceleration of depreciation deductions, a second major issue is whether it is appropriate to do so by increasing the ADR variance or by use of a cost recovery approach which is not related to estimated useful lives. A third major issue is whether it is appropriate to provide additional depreciation benefits to small business by allowing eligible businesses to use statutorily prescribed depreciation lives for depreciating certain classes of assets (under a straight-line method) rather than using actual useful lives.

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[6] In computing this item of tax preference, accelerated methods of depreciation can be used to determine the amount of depreciation otherwise allowable (at least where such methods are consistent with the taxpayer's treatment of the portion of the basis of the facility which is not eligible for amortization). Reg. §1.57-1(d)(4).

The fourth major issue is whether it is appropriate to reduce the amortization period for pollution control facilities from 60 months to 24 months (and to provide that this accelerated deduction is not a tax industrial development bond. Also, the investment credit limitation preference).

B. Description of S. 231

Explanation of provisions

ADR system

The bill would increase the asset depreciation range from 40 percent (i.e., 20 percent above or below the asset guideline period) to 60 percent (30 percent above or below the asset guideline period). Thus, under the bill, the asset depreciation range would be a period of years which extends from 70 percent of the asset guideline period to 130 percent of such period. Any fractional part of a year would be rounded to the nearer of the nearest whole or half year.

With respect to the determination of depreciable basis of eligible property under the ADR system, the bill would provide that salvage value may be ignored. Thus, eligible property may be depreciated to a zero adjusted basis.

Small business depreciation schedules

The bill also would allow small businesses to use an abbreviated table of useful lives for depreciation purposes. It would give small firms the opportunity to choose useful lives for assets which are shorter than the useful lives that other businesses can use. The shorter lives are set so that the present value of the economic benefits of straight line depreciation using those lives in equivalent to the benefits which bigger firms receive using ADR lives and double declining balance depreciation. The lives for different assets would be set forth in a table.

The proposed system would be available to any business with an adjusted tax basis in assets (other than most real estate assets) of $250,000 or less. It is intended that the use of shorter lives would not affect the small business' ability to use the investment tax credit which would have been available if it had used the longer normal ADR lives.[7]

[7] It is not clear that the bill language accomplishes this. A technical amendment may be required to ensure that the regular ADR lives can be used for purposes of the investment tax credit.

The straight line depreciation table prescribed by the bill for small business assets would be as follows:

DEPRECIATION LIVES FOR SMALL BUSINESS ASSETS

Asset	*Years*
Specific depreciable assets used in all business activities:	
Office furniture and fixtures	5
Information systems (computers) and other data handling equipment	2
Airplanes	2
Automobiles	1
Buses	4
Light trucks	1
Heavy trucks	2
Truck trailers	2
Vessels and barges	9
Land improvements	14
Depreciable assets used in broad activity groups:	
Farming assets	5
Farm buildings	12
Mining	5
Construction	2
Manufacturing:	
A. Production of electronic products, textured yarn, sawmill and logging operations and oil well drilling	3
B. Production of machinery; metal, stone and clay, glass, rubber, chemical, wood, plastic, textile, apparel, leather, paper, electric and aerospace products; boat building, and printing and publishing	5
C. Production of grain, sugar and vegetable food products, tobacco products, and petroleum refining	8
Wholesele and retail trade, recreational activities, and personal and professional services	5

Effective date

The provisions of the bill would apply to property placed in service in taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce budget receipts by $1 billion in fiscal year 1980, $1.6 billion in fiscal year 1981, $2.1 billion in fiscal year 1982, $2.6 billion in fiscal year 1983, and $3.1 billion in fiscal year 1984.

Other issues for committee consideration

The committee may wish to consider a number of other issues which relate to this new small business depreciation approach. Most of these issues are relatively technical, and solutions to the problems raised may well be achievable without jeopardizing the basic policy goals of the proposal. One issue is whether the value of assets test as proposed is appropriate. (Some technical problems may also be present involving the time for testing, the appropriate assets to be included, and the appropriateness of adjusted basis as a measure.) Another issue is

whether controlled group and related party rules need to be adopted for purposes of preventing avoidance of the asset limitation. Another issue is how these provisions are to be coordinated with other rules such as the minimum tax and the recapture rules. Still another issue is what conventions (half-year, modified half-year, etc.) should be allowed, or required, in connection with this proposal. An additional issue is whether these useful lives would apply to leased property (or whether, or to the extent, this proposal is limited by the use of the term "business"). There may also be some definitional problems concerning the definition of "real estate" for purposes of the exclusion; also it is not clear whether the asset limitation applies at the partner level or the partnership level.

C. Description of S. 935

Explanation of provisions

Depreciation

The bill would provide, in general, that a taxpayer could elect to depreciate tangible personal property, and certain other tangible property which is eligible for the investment credit (i.e., property described in sec. 48(a)(1)(B)), over a period of not less than 5 years. The useful life selected for depreciation purposes also would be used for investment tax credit purposes. This election could be made on a property-by-property basis, but if a taxpayer made this election for any eligible property, the taxpayer would be required to use the half-year convention (which treats all eligible property as being placed in service on the first day of the second half of the taxable year) for all eligible property. Also, the taxpayer would not be permitted to deduct additional first year depreciation (under sec. 179) with respect to property for which an election has been made.

Amortization of pollution control facilities

The bill also would shorten the period over which the amortizable basis of any certified pollution control facility could be amortized from 60 months to 24 months. Further, the bill would repeal the provision of the Code (sec. 57(a)(4)) which provides that, for purposes of the "add-on" minimum tax the excess of the amortization deduction for pollution control facilities over the depreciation deduction otherwise allowable is a tax preference.

Effective date

The provisions of the bill would apply to property placed in service on or after the date of enactment.

Revenue effect

It is estimated that the bill would result in a reduction in budget receipts of $1.2 billion in fiscal year 1980, $4.4 billion in fiscal year 1981, $7.3 billion in fiscal year 1982, $8.5 billion in fiscal year 1983, and $10.2 billion in fiscal year 1984.

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III. S. 700

INVESTMENT TAX CREDIT FOR CERTAIN RESEARCH AND EXPERIMENTAL EXPENDITURES

A. Present Law and Issue

Present law

Investment tax credit

A credit against income tax liability is provided for a taxpayer's investment in certain types of depreciable business assets with a useful life of three years or more. Generally, the rate of this credit is 10 percent of qualified investment.

Property eligible for the investment tax credit includes tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit is also allowed for other tangible property which is used as an integral part of manufacturing, production, extraction, or in furnishing certain utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Buildings (including structural components) and intangible property are not generally eligible for the credit (Regs. § 1.48–1).[1]

Research and experimental expenditures

Present law also provides an option with respect to the tax treatment of research and experimental expenditures. Under these provisions, a taxpayer may elect to deduct research and experimental expenditures in the year incurred (Code sec. 174(a)), or the expenditures may be capitalized and amortized on a straight-line basis over a period of at least 60 months beginning with the month the taxpayer first realizes benefits from these expenditures (Code sec. 174(b), Regs. § 1.174–4). The amortization method is available only if the property resulting from the expenditures does not have a determinable useful life. An election of either of these methods is binding on the taxpayer for all subsequent taxable years unless a different method is authorized by the Internal Revenue Service.

Research and experimental expenditures for purposes of these provisions are those trade or business expenditures incurred by the taxpayer directly or by someone else (such as a research institute or an engineering company) on his behalf, to develop a product, a pilot model, a plant process, a formula or an improvement to property of this type (Regs. § 1.174–2(a)). The term also includes the costs of ob-

[1] However, agricultural and horticultural structures, rehabilitation expenditures for certain buildings, and motion picture films and video tapes are eligible for the credit under specific statutory provisions. (Code secs. 48(a)(1)(D), 48(a)(1)(D), 48(a)(1)(E), and 48(k).)

taining a patent on this property. (When a patent is issued, the unrecovered research and experimental expenditures attributable to the patent must be amortized over the term of the patent (Regs. § 1.174–4(a)(4).) Research and experimental expenditures do not include costs for acquiring land and depreciable or depletable property, including such property acquired in the course of research or experimental work (Code sec. 174(c)). However, depreciation and depletion deductions with respect to such property used in connection with research and experimental activities are considered as research and experimented expenditures. In addition, the term does not include costs of acquiring another's patent, model, production or process and it does not include research expenditures in connection with literary, historical and similar projects.

Issue

The issue is whether the investment credit should be extended to research and experimental expenditures.

B. Description of the Bill

Explanation of provisions

The bill would extend the investment credit to research and experimental expenditures, as defined under the present statutory provisions which allow taxpayers to deduct or amortize these expenditures. Thus, for this purpose the qualified research and experimental expenditures paid or incurred by the taxpayer during a taxable year would be eligible for the credit, i.e., the credit base would be the total qualified expenditures paid or incurred whether the taxpayer elected to take a current deduction or elected to capitalize and amortize these expenditures.

Effective date

The provisions of the bill would apply to qualifying expenditures made in taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will reduce budget receipts by $0.8 billion in fiscal year 1980, $2.0 billion in fiscal year 1981, and $2.3 billion in fiscal year 1982.

Other issues for committee consideration

The committee may wish to consider whether the investment credit should not be extended to depreciation deductions which are treated as qualified research and experimental expenditures in order to prevent allowance of double credits with respect to the same item, e.g., an initial credit would be allowed with respect to the cost of the property under the regular investment credit provisions (for example, when the property is first placed in service) and also a second credit would be allowed with respect to depreciation on the property if it is treated as a research and experimental expenditure.

IV. S. 1003

BAD DEBT RESERVES, EXPORT MARKET DEVELOPMENT EXPENDITURES, AND FOREIGN CURRENCY LOSSES

A. ESTIMATION OF BAD DEBT RESERVE FOR EXPORT RECEIVABLE

1. Present Law and Issues

Present law

Under present law taxpayer can take a deduction for a business bad debt in the year the debt actually becomes worthless or he can take a deduction for a reasonable addition to a reserve for bad debts in the year the debt arises. The reserve method is intended to reflect the amount of accounts receivable that arose in the current year that are expected to become worthless in some future period. The taxpayer's bad debt deduction under the reserve method is limited, in general, to the historical percentage that his actual bad debt bears to his accounts receivable.

Issues

The issue is whether taxpayers engaged in the business of exporting goods and services should be allowed a deduction for an addition to a bad debt reserve that may be greater than the amount of the deduction the taxpayer would have been allowed using his historical bad debt percentage. Also at issue is whether this provision would be considered to inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would allow taxpayers who are engaged in the trade or business of selling export property for use or for services rendered for use outside the United States to establish a separate bad debt reserve for that trade or business. Under this provision, the special bad debt deduction for the year would be equal to the greater of:

(1) 15 percent of the taxable income which is from sources outside the United States and which is attributable to the export operation, or

(2) 2 percent of the taxpayer's accounts receivable which are outstanding at the close of the year and which arose from the sale of export property or services outside the United States.

The taxpayer's export bad debt deduction for any year would be limited in that it could not cause the taxpayer's export bad debt reserve to exceed a ceiling equal to 5 percent of the export receivables outstanding at the end of the year.

Effective date

This provision would be effective for taxable years beginning after September 30, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $86 million in fiscal year 1981, $164 million in fiscal year 1982, $88 million in fiscal year 1983, $35 million in 1984, and $39 million in fiscal year 1985.

B. TAX TREATMENT OF CERTAIN EXPENDITURES TO DEVELOP FOREIGN MARKETS AND FOREIGN PATENTS

1. Present Law and Issues

Present law

Expenditures made in the conduct of a trade or business which relate to an asset that has a useful life substantially beyond the taxable year must be capitalized rather than currently expensed. This capitalized expenditure may be amortized over the useful life of the asset. If the useful life cannot be ascertained, the capitalized expenditure will be part of the asset's basis which will be subtracted from the sales price of the asset if and when it is eventually sold.

Under present law, certain amounts paid with respect to exploring and developing a new business must be capitalized by taxpayers who are not already engaged in that business. These expenditures usually occur in the period the taxpayer is investigating the possibility of establishing the new business, and in the period after the taxpayer has decided to establish the business but before it is actually operating. Since these expenditures relate to the new business itself, rather than a tangible asset, they would be amortizable over the life of the business or product. However, since the useful life of a business or a product is, generally, not readily ascertainable, such capitalized expenditures usually cannot be amortized.

In the situation where the foreign business is not a new business but an extension of an existing business, expenditures for the development of foreign markets and foreign products are, in general, presently being deducted by taxpayers. It is not completely clear as to the deductibility of some expenses (e.g., market or product studies) relating to the extension of an existing business into a foreign market.

Under current law, the Internal Revenue Service has held that the cost of acquiring a foreign patent where the U.S. patent is owned by another party is not deductible.

Issues

The issue is whether taxpayers should be permitted to elect to deduct currently, or to amortize over a 60-month period rather than capitalize the cost of establishing foreign markets and foreign products and the cost of acquiring and maintaining foreign patents and trademarks. Also at issue is whether this provision would be considered inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would provide that the taxpayer could elect to treat the following amounts as research or experimental expenditures for purposes of section 174 of the Code:

(1) Amounts paid in connection with the survey or analysis of foreign markets and foreign products;

(2) Amounts paid in connection with marketing U.S. goods outside the United States, including amounts paid in adapting U.S. products to meet foreign market requirements; and

(3) Amounts paid in applying for, and maintaining, international and foreign patents and trademarks for use in the taxpayer's trade or business. (This provision would apply regardless of whether the taxpayer is the owner of the U.S. patent or the owner of the rights to the U.S. patent.)

Treatment of these costs as research or experimental expenditures under section 174 would permit the taxpayer to elect to deduct such expenditures as expenses in the year incurred or amortize them over a 60-month period.

Effective date

This provision would apply to taxable years beginning after September 30, 1980.

Revenue effect

The revenue effect of this provision is estimated to reduce budget receipts by less than $5 million annually.

C. The Tax Treatment of Foreign Currency Losses on Export Receivables

1. Present Law and Issues

Present law

As a general rule, gains and losses are not taken into account as income or deductions until the gains and losses are realized. An increase in the value of an asset held by a taxpayer will not be included as income, and a decrease in the value of an asset will not be allowed as a deduction, until the amount of the gain or loss is fixed by a sale of the asset or some other realization event. One application of this general rule is that foreign currency gains and losses on accounts receivables are not taken into account until the receivable is actually paid.

Foreign currency losses on accounts receivable usually arise where a taxpayer sells a product with a sales price denominated in a foreign currency. An accrual basis taxpayer will include in income on the sale date the dollar value of the sales price. If the value of the foreign currency declines relative to the dollar in the time between the sale date and date of payment, the taxpayer will have a currency loss equal to the difference between the dollar equivalent of the amount initially taken into income on the foreign currency contract and the dollar equivalent of the amount finally paid on the contract. (He will receive the same number of units of the foreign currency that were originally bargained for but they will translate into fewer dollars on the date the receivable is paid as opposed to the date the receivable arose.) Conversely, if the dollar depreciates in value in the period between the time of sale and the time of payment, the taxpayer will have a foreign currency gain which is includible in income in the year the payment is made.

These rules may be illustrated by an example of a taxpayer who sold his product to a United Kingdom corporation for 200 pounds sterling on October 1, 1979, at a time when 200 pounds would translate into $400, but the account receivable was not paid until March 1, 1980, when 200 pounds would only translate into $300. Since, under the accrual method of accounting, the taxpayer recorded the sale at $400 in 1979, he will now show a $100 loss in 1980 to reflect the fact that ultimately he only received $300 on the sale of his product. If the depreciation of the foreign currency relative to the dollar actually occurred on December 1, 1979, under current law the taxpayer may not recognize the loss in 1979 but instead must show income on the sale of $400. The taxpayer may recognize the loss only in the year the receivable is paid and the loss is fixed, i.e., 1980.

Issues

The issue is whether the present rule that currency gains and losses cannot be included in income until they are fixed by final payment should be modified to allow a taxpayer to elect annually, on a currency-by-currency basis, to deduct foreign currency losses in the year the depreciation occurs rather than the year in which the receivable is actually paid. Also at issue is whether this provision would be considered inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would allow the taxpayer an annual election, on a currency-by-currency basis, to deduct foreign currency losses incurred on export receivables. Export receivables are receivables that arise from the sale of export property and services for use outside the United States. The foreign currency loss is the decline in the dollar value of an export receivable at the later of the beginning of the year or when the receivable arises over the dollar value of that export receivable at the end of the year.

The foreign currency loss is only allowed to the taxpayer whose trade or business created the export receivable. Thus, financial institutions that purchase export receivables as part of a factoring business would not be allowed this deduction.

When the export receivable is actually paid the taxpayer would recapture any losses taken under this provision in excess of its actual foreign currency loss.

In determining the taxpayer's bad debt deduction, the amount of the receivable would be its adjusted basis less all foreign currency losses taken with respect to that receivable.

Effective date

This provision will be effective for taxable years beginning after September 30, 1980.

Revenue effect

The revenue impact of this provision is indeterminate because of uncertainties about future exchange rate fluctuations.

V. S. 1065

INCOME TAX CREDIT TO CORPORATIONS FOR CHARITABLE CONTRIBUTIONS FOR BASIC RESEARCH

A. Present Law and Issue

Present law

Present law provides a Federal income tax deduction, within certain limitations, for contributions of cash or property to qualified charitable organizations, including colleges and universities (sec. 170). In the case of a corporate donor, the deduction is limited to five percent of the corporation's taxable income (computed with certain adjustments). To be deductible for a particular taxable year, the contribution must either be made within the corporate taxable year or accrued within that year and paid within two and a half months after the close of the year.

If a corporation makes an otherwise deductible charitable contribution exceeding the five-percent limitation, the excess may be carried forward for five succeeding years. The carryforward is added to the subsequent year's charitable contributions and may be deducted subject to the five-percent limitation as computed for the carryforward year.

Issue

The issue is whether corporations should be provided a Federal income tax incentive, in addition to the present law deduction for charitable contributions, to contribute funds to educational organizations to be used for scientific basic research.

B. Description of the Bill

Explanation of provisions

General rules

The bill would provide corporate taxpayers (other than subchapter S corporations) a nonrefundable credit against Federal income tax liability for charitable contributions paid in cash during the taxable year to qualified educational organizations, if as a condition of the gift the donee must use the contribution exclusively for scientific basic research. The bill would define scientific basic research as "fundamental research in the physical sciences the results of which are fully available to the general public." To qualify for the credit, the contribution would have to be made to an educational organization, other than a primary or secondary school, which is otherwise eligible to receive tax deductible donations.

The amount of the credit would be 25 percent of the qualified basic research contributions, adjusted according to a formula. The formula

would reduce the qualified basic research contributions actually made (1) by the average of the amounts contributed for qualified basic research over the preceding four taxable years, and (2) by the amount of any reduction in other charitable contributions for the taxable year. Charitable contributions (other than qualified basic research contributions) would be considered to be reduced if they were less than the preceding four-year average. Thus, the new 25-percent credit would generally apply only to charitable contributions earmarked for scientific basic research, and after the first year would apply only to the extent of increases in such contributions. The formula is designed so that the amount eligible for the credit would be reduced if gifts normally given to charitable organizations for other purposes were reduced.

The new basic research credit would be in addition to the present law deduction for charitable contributions. Therefore, a qualifying contribution for scientific basis research could be eligible for both the basic research credit and the charitable deduction.

Controlled group of corporations

The bill would treat all members of the same controlled group of corporations as one corporation for purposes of applying the basic research credit rules. In the case of a controlled group of corporations, each member of the group would be allowed a credit based on its proportionate contribution of qualified basic research contributions which give rise to the credit.

In determining which corporations are members of a controlled group of corporations, the corporate controlled group rules would generally apply (sec. 1563). However, the normal rule which requires at least 80-percent control in a parent-subsidiary controlled group would be changed for purposes of this provision. Under the bill, generally, there would be a parent-subsidiary controlled group if one corporation has more than 50-percent control of another corporation.

Adjustment for certain acquisitions

If a taxpayer acquires the major portion of a trade or business, then for purposes of applying the basic research credit rules for any year ending after the acquisition, the amount eligible for the basic research credit would be adjusted by charitable contributions made by the acquired trade or business. With respect to the taxpayer disposing of a major portion of a trade or business, its charitable contributions for purposes of determining the amount eligible for the basic research credit would also be adjusted.

Effective date

The provisions of the bill generally would apply to taxable years beginning after December 31, 1979.

For taxable years beginning before January 1, 1984, the formula for computing the amount of the qualified basic research contribution to which the credit applies would take into consideration only qualified basic research contributions made in taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will reduce budget receipts by $8 million in fiscal year 1980, $20 million in fiscal year 1981, and $22 million in fiscal year 1982.

VI. APPENDIX TABLES

Table 1.—Comparison—U.S. Merchandise Trade Balance—Imports Valued C.I.F. Versus F.A.S.[1]

[Billions of dollars]

	Import f.a.s.[1]	Imports c.i.f.[1]
1970	2.6	0.8
1971	−2.3	−5.0
1972	−6.4	−10.0
1973	0.9	−3.1
1974	−5.3	−9.5
1975	9.0	4.2
1976	−9.4	−14.6
1977	−31.1	−36.3
1978	−28.5	−39.6
1979: I[2]	−7.4	−11.3

[1] C.i.f.—cost, insurance, freight; f.a.s.—free alongside ship.
[2] First quarter of 1979.

Source: U.S. Department of Commerce.

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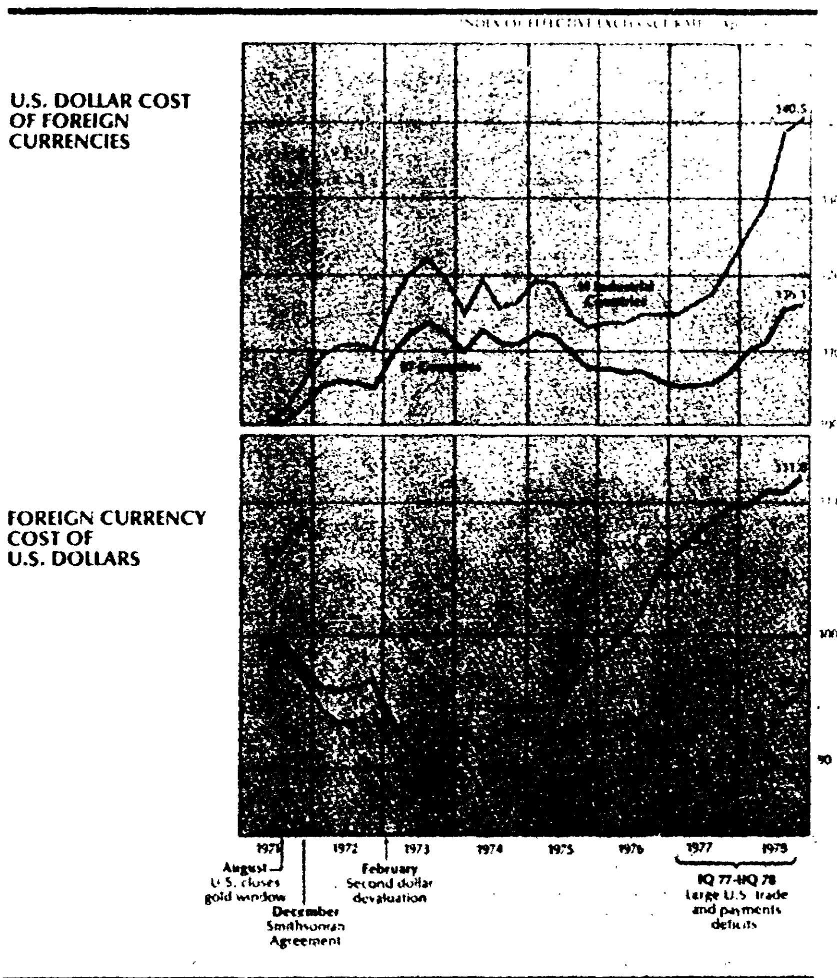
Table 2.—Index of Effective Exchange Rates



Source: Commerce Department, International Economic Indicators (March 1979).

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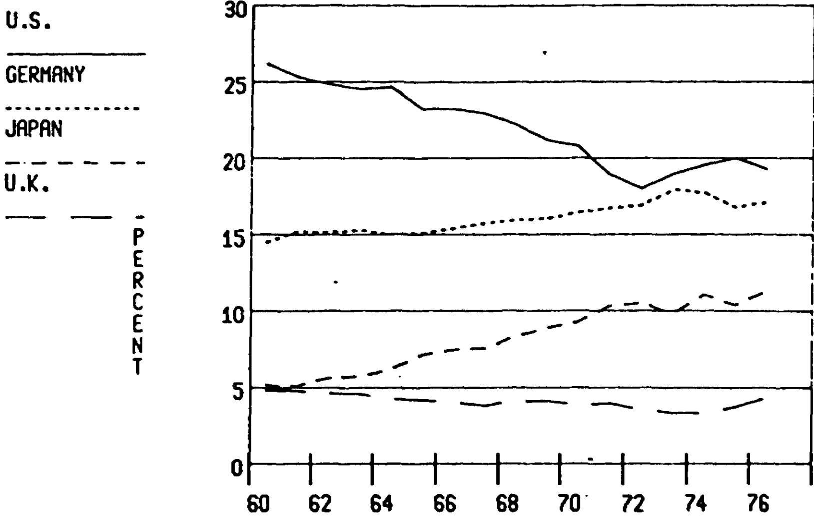
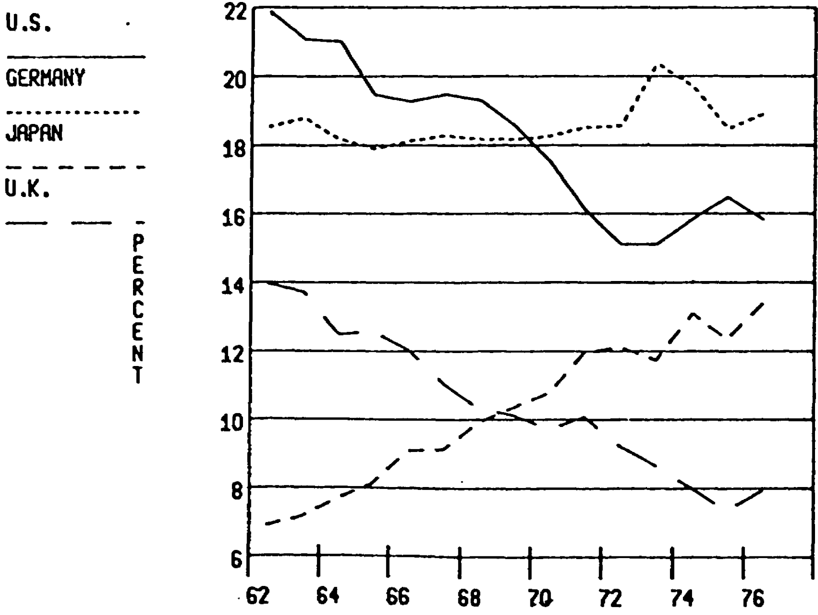
Table 3.— Export Shares

Figure 1



SOURCE:
IMF INTERNATIONAL FINANCIAL STATISTICS

Figure 2



A Positive Foreign Economic Policy

"In this period of international instability and highly politicized competition, we have a tricky course to steer. And what worries me is that nobody is steering it. Issues of great international importance are being decided on the basis of short-term political advantage. We are drifting wherever the political winds blow."

The forces of nationalism and protectionism are on the rise around the world. If the United States, the world's largest economy, does not continue to press for interdependence, expanding trade and investment, and the growth of the world economy—there is no other nation to take the leadership. If we begin to build walls to keep out the rest of the world and let the dollar lose its position as the world's reserve currency—then the consequences, for us and for the rest of the free world, could be grave indeed.

ECONOMIC NATIONALISM: A STEP BACKWARD

Protectionism and economic nationalism have a long and sorry history. They were characteristic of the mercantilist period, a time of perpetual warfare, when the nations of Europe were building and exploiting their worldwide empires. It was Colbert, Finance Minister to Louis XIV, who set forth the characteristic argument for protectionism when he wrote, "All purchases must be made in France rather than in foreign countries, even if the goods be a little poorer and a little more expensive, because if the money does not go out of the realm, the advantage to the state is double." One can see the dead hand of Colbert in the highly restrictive purchasing regulations of many European nations today.

That was also the time when royal governments granted monopolies to chartered trading companies such as the Dutch, French, and English East India Companies, the Virginia Company, and the Massachusetts Bay Company. They were empowered to manage trade with the colonies in such a way as to maximize the benefits to the home country. It was such economic exploitation that eventually triggered the American Revolution and led to our tradition, here, of limited government and competitive private enterprise.

In the past two centuries, with the rise of capitalism and democratic governments, the world has moved in fits and starts toward a more creative concept of free and fair trade among the nations. But the traditions of economic nationalism remain strong. ready to reassert themselves in times of trouble.

Our last experience with protectionism in the United States was the Smoot-Hawley Act of 1930. Smoot-Hawley was supposed to stop imports without seriously affecting exports. But within a few months, the level of total U.S. trade had declined by more than 30 percent. Moreover, it worsened the worldwide depression, and in a decade the world was at war. There were many other contributing causes, but once nations begin to shut themselves off from each other and adopt beggar-thy-neighbor policies, the chances for tension, instability, and disaster are greatly increased.

That is why we must be concerned about the sorry state of U.S. trade today, the falling dollar and rising cries for protectionism—and the lack of any positive and coherent policy to do anything about it.

THREE POSTWAR CYCLES

To understand where we stand today, we have to recognize that there have been three distinctive cycles in the world economy since the end of World War II.

From 1945 to 1955, we had the era of reconstruction. Europe and Japan lay devastated, and Stalin was on the prowl. The United States took the lead, by way of the Marshall Plan, in rebuilding the economies of the free world—and that included friends and former enemies alike.

Then, from 1955 to 1970, we had the greatest expansion of trade and investment the world has ever known. Trade barriers fell, worldwide enterprises emerged, and the third world began to drive for economic development. The world wide movement of people, goods, and capital brought abundance to the industrialized nations and hope to those who had not yet industrialized.

But imbalances developed, and around 1970 we moved into the third postwar cycle—the cycle of consolidation and restructuring that began with the breakdown of the Bretton Woods agreements, was further disrupted by the arbitrary action of the OPEC cartel, and has clearly moved the compass from interdependence toward nationalism. For the United States, this means adjustment to the fact that though we are still the world's largest economy, we no longer have the technological financial, or cost-competitive advantages we once enjoyed. The competition is more

difficult now, and the old *noblesse oblige* that allowed us to hand advantages to our trading partners is no longer appropriate.

In this period of international instability and highly politicized competition, we have a tricky course to steer. And what worries me is that nobody is steering it. Issues of great international importance are being decided on the basis of short-term political advantage. We are drifting wherever the political winds blow. Neither the Administration nor the Congress seems to care whether we have a strong, peaceful and growing world economy in which the United States can achieve its own objectives of economic progress, high employment, and a dollar that's worth a dollar here and abroad.

THE SORRY STATE OF U.S. TRADE

Consider the sorry state of the United States today in world trade. (Chart 1) We have moved from a $9 billion trade surplus in 1975 to a $29 billion trade deficit in 1977. That's a $38 billion change in two short years. And further trade deficits on the order of $25 to 30 billion are forecast, for the next two years at least.

Not unrelated to that: the dollar is in trouble. (Chart 2) it has declined sharply against the currencies of our trading partners, and especially against the Japanese yen tand the West German mark.

Our oil imports (Chart 3) are still increasing four-and-a-half years after the oil embargo, going form $8 billion in 1973 to $45 billion in 1977. Europe and Japan—which have very little oil of their own-are astounded. by allowing their oil and gas prices to rise to world levels, they have brought their consumption of foreign oil under control and are moving toward greater use of nuclear power. But our growing dependence on imported oil helps OPEC keep world petroleum prices up, and is a major cause of our huge trade deficit.

But that deficit is not simply an oil problem. (Chart 4) Our trade position in manufactured goods has also deteriorated. In 1975 our growth rate in manufactured exports was 12 percent. By 1977 that had slipped to 4 percent. Meanwhile, our manufactured imports—which actually went down by 8 percent in 1975—went up 27 percent in 1976, and 19 percent more in 1977. In other words, last year our manufactured imports were growing four or five times as fast as our manufactured exports.

Chart 5, based on the latest Commerce Department data, shows how our trade balance in manufactured goods—after improving in 1975—narrowed 1976 and '77, and actually moved to a slight deficit in the forth quarter of 1977.

This is a serious matter because our economy has become increasingly dependent on foreign trade in recent years. Exports of goods and services last year amounted to 9.2 percent of our gross national product, and exports are now estimated to provide more than eight million jobs in the United States.

The longer range picture (Chart 6) shows that we have been steadily losing our markets to foreign competitors, backed and encouraged by their governments. Twenty years ago, United States companies had about 28 percent of the world market for manufactured exports—excluding exports to the U.S. By 1968 our share had been whittled down to 24 percent, and last year we were lucky to get about 20 percent.

So we have a record $29 billion trade deficit, the dollar is shaky, and we're losing our export markets and the related jobs to foreign competition. Yet this country has literally no foreign economic policy or program to deal with the problem. I say we're in trouble.

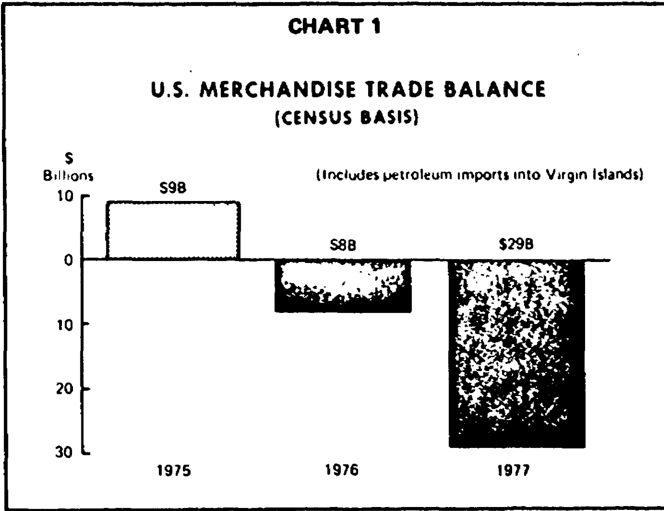


CHART 1
U.S. MERCHANDISE TRADE BALANCE
(CENSUS BASIS)
$
Billions
(Includes petroleum imports into Virgin Islands)
$9B
$8B
$29B
10
0
10
20
30
1975
1976
1977

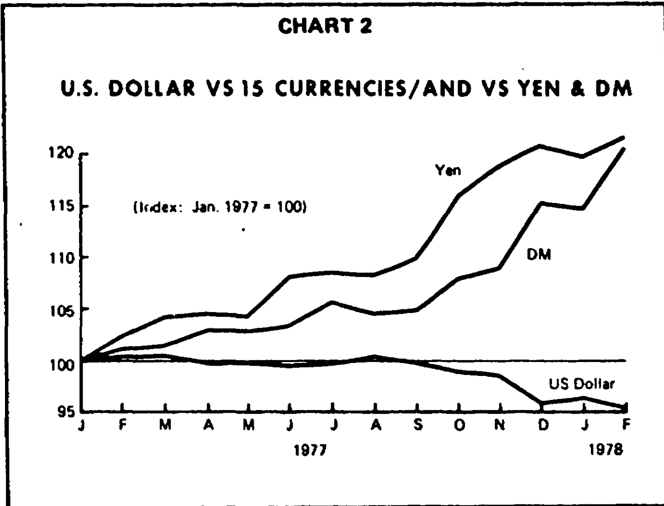


CHART 2
U.S. DOLLAR VS 15 CURRENCIES/AND VS YEN & DM
(Index: Jan. 1977 = 100)
Yen
DM
US Dollar
120
115
110
105
100
95
J
F
M
A
M
J
J
A
S
O
N
D
J
F
1977
1978

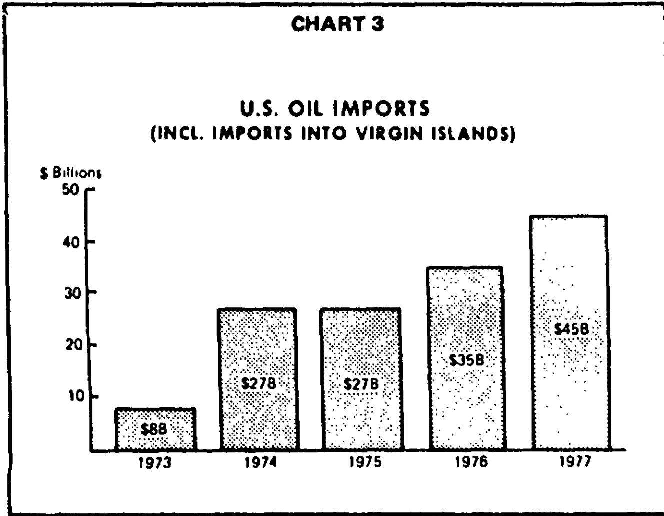


CHART 3
U.S. OIL IMPORTS
(INCL. IMPORTS INTO VIRGIN ISLANDS)
$ Billions
50
40
30
20
10
$8B
$27B
$27B
$35B
$45B
1973
1974
1975
1976
1977

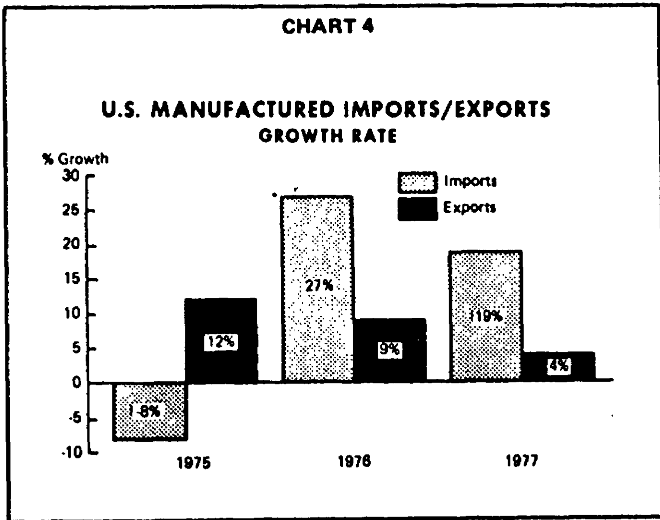


CHART 4
U.S. MANUFACTURED IMPORTS/EXPORTS
GROWTH RATE
% Growth
30
25
20
15
10
5
0
-5
-10
Imports
Exports
-8%
12%
27%
9%
19%
4%
1975
1976
1977

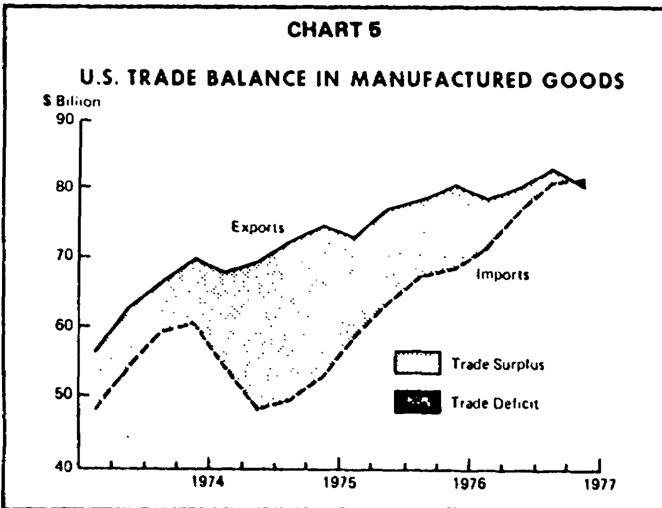


CHART 5
U.S. TRADE BALANCE IN MANUFACTURED GOODS
$ Billion
90
80
70
60
50
40
Exports
Imports
Trade Surplus
Trade Deficit
1974
1975
1976
1977

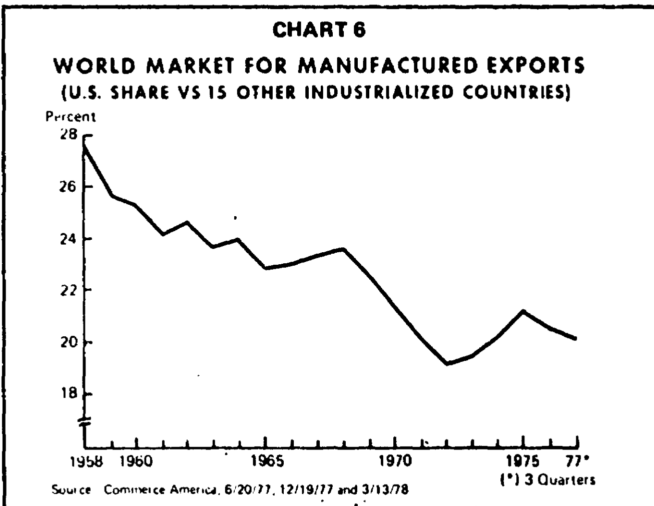


CHART 6
WORLD MARKET FOR MANUFACTURED EXPORTS
(U.S. SHARE VS 15 OTHER INDUSTRIALIZED COUNTRIES)
Percent
28
26
24
22
20
18
1958
1960
1965
1970
1975
77*
(*) 3 Quarters
Source Commerce America, 6/20/77, 12/19/77 and 3/13/78

THREE OPTIONS

What options does the United States have, in dealing with this crisis?

Further devaluation of the dollar? Amazingly, there is some support for this. But it would be highly inflationary, increasing the costs of imported raw materials and manufactured goods. William Miller, the new Chariman of the Federal Reserve Board, recently stated that the devaluation of the dollar has already added 0.5 to 0.75 points to inflation since September. If the value of the dollar declines much further, the OPEC countries will be sorely tempted to raise their prices or—worse yet—refuse to accept dollars for their oil. The world needs a stable reserve currency, and the free world properly looks to the United States for leadership in this respect.

Should we try to solve the problem by blocking imports? Protectionism is a policy of desperation. Of course we should prevent dumping and provide more realistic adjustment assistance to workers in industries that can no longer meet foreign competition. But quotas and tariff walls are a dangerous game, inviting retaliation and excalation that could end up with worldwide recession. The U.S. market, being the largest in the world, is essential to the world economy. The solution of most economic and social problems, especially in the less developed countries, requries expanding trade, not closed borders and declining trade.

Then how about expanding exports? This option has hardly been considered, but it is the most positive and promising answer to our trade dilemma. It strengthens the dollar and encourages world trade. It also has the virtue of expanding employment and fighting inflation here at home. Clearly, this is the way to go.

A POSITIVE FOREIGN ECONOMIC POLICY

What can the U.S. government do, with industry assistance, to develop and implement a positive foreign economic policy—designed specifically to expand exports and the related jobs?

The starting point must be to respond to the exporting efforts of other governments. The Japanese, the Germans, the French, the less developed countries—virtually all other governments look to exports to solve their economic and employment problems. They provide aggressive export promotion. This includes favorable governmental financing assistance well beyond what the Export-Import Bank and other U.S. agencies have been able to do. Many of these foreign nations also protect their home markets through various trade barriers, of both the tariff and non-tariff type. This gives their exporters a protected home base for sales and profits. It also enables their exporters to have competitive advantage in third-country markets through incremental pricing. In addition, of course, in some cases foreign exporters may receive considerable government subsidization for their exports, enjoy tax advantages, and can look to government officials for personal assistance in sales involving intergovernmental relations.

So the United States must recognize these realities of trade today and try to offset or neutralize the exporting efforts of other governments.

The Administration sould reestablish the Export Council and Interagency Committee on Export Expansion, to generate effective export programs.

The Export-Import Bank must be able to offer more competitive financing arrangements.

U.S. exporters need better export insurance and greater protection against the political risks of foreign trade and investment.

Bilaterial trade agreements should be negotiated with the less developed countries, recognizing their special needs and problems. Such government-to-government agreements are a great advantage to our Japanese and European competitors.

The United States should promote high-technology exports, a traditional area of U.S. leadership.

Our government should also do more to promote exports of our service industries: tourism, transportation, international banking, and others.

And State Department and other government personnel overseas should be instructed to be much more helpful in assuring the participation of U.S. companies in projects in foreign lands.

At the same time, we need a determined effort to reduce the unfair and artificial barriers to U.S. products abroad. The GATT treaty was originally negotiated in the postwar reconstruction period, when we were willing to give away trade advantages in order to help our former enemies and allies to recover. Now those conditions are changed, and the terms of trade and competition must be made more equal. Special Trade Representative Robert Strauss has a tough and important task ahead in the GATT negotiations.

ENCOURAGE EXPANSION OF U.S. COMPANIES ABROAD

Another important plank of our foreign economic policy must be a decision to encourage—not discourage—the expansion of U.S companies abroad. Other countries have encouraged and helped the expansion of their multinational companies, recognizing their importance in winning export orders and foreign-source income. The worldwide sales of the 200 largest non-U.S. firms have in recent years been rising almost twice as rapidly as sales of the 200 largest U.S. firms. There are now more non-U.S. than U.S. companies in the billion-dollar-sales club. And perversely, our government seems intent on discouraging the growth of U.S. companies that operate on a world scale.

The hate campaign against the so-called multinational companies in this country is based largely on a misreading of the situation by organized labor, though there is also an ideological campaign with Marxist overtones at the United Nations and the World Council of Churches. The unions allege that U.S. companies with foreign affiliates are "exporting jobs" and manufacturing abroad in order to produce low-priced goods to sell in the United States.

Actually, Commerce Department data show that less than 7 percent of the output of U.S. foreign affiliates comes back to the United States, and half of that is from Canada under the automotive pact. Even in that small percentage of cases where the overseas operations do provide components or products for the U.S. markets, they are usually defensive operations that protect other U.S. jobs in industries where the products cannot be competitively manufactured in the United States. If we did not have those overseas operations in electronics, for example, Japanese companies would get virtually all the business in the United States. Those overseas jobs would not revert to the United States.

In 93 percent of the cases, however, the foreign affiliates are producing goods for foreign markets, and they are also pulling through exports and providing jobs in the United States. Consider General Electric's experience, for example. Our Company had a trade surplus of nearly $2 billion in 1976, and about the same in 1977. International business is providing 47,000 GE jobs in the U.S., plus some 44,000 jobs among our U.S. suppliers.

Now the point is that our foreign affiliates are essential in providing that high level of exports and jobs in our U.S. factories and offices. When we establish or expand a foreign affiliate, the result is almost always a sharp increase in export sales to that country out of production from our U.S. facilities. Our exports to Netherlands went from $3 million to $79 million annually in the dozen years since we established our affiliate there. In Australia they rose from $1.5 million to $45 million. The same thing happened in Mexico, Brazil, Belgium, and elsewhere. The unions and their political allies must be made to understand that the overseas affiliates are essential in order to pull through export business against on-the-spot competition. They create jobs and economic progress in the host countries, but they also provide additional jobs and income for the United States.

DON'T MAKE MATTERS WORSE

Yet another plank of our foreign economic policy should be—don't make matters worse by throwing more obstacles in the way of U.S. exporters.

For example, the Administration proposes to tax foreign-source income before it is received by the U.S. taxpayer—popularly referred to as "phasing out deferral." This proposal, clearly designed to weaken or discourage U.S. affiliates overseas, would be foolish in every respect. No other country in the world taxes foreign-source income until it is repatriated, and some, such as France and the Netherlands, do not tax foreign-source corporate income at all. They realize the importance of strong overseas affiliates in maintaining a high level of exports and jobs back home.

If the Congress decides to tax the income of our foreign affiliates before it comes to the United States, foreign governments may tax that income first through higher taxes. Thus the U.S. Treasury, by its own admission, may gain little or nothing in terms of revenue. It would be a tax increase for business but not a tax gain for the U.S. government. How illogical and self-destructive can we get?

The Administration also proposes to phase out the DISC provisions which defer taxes on part of the income derived from export business. I guess Washington just refuses to understand how DISC funds are valuable to exporters in three ways: they provide a partial offset to the tax rebates that European governments grant to their companies who export; they provide working capital for the long-term receivables that are characteristic of the export trade; and they provide long-term market development funds. For example, General Electric spent four profitless years establishing a presence in Nigeria before we finally won an $11 million export order.

So for the United States to phase out deferral and DISC at a time when this country is running trade deficits approaching $30 billion a year would be like unilateral disarmament in the battle for exports and jobs.

Instead of increasing taxes, the Congress should *reduce* the excessive taxation of U.S. personnel working abroad, under Section 911 of the Tax Code.

And under the heading of "Don't make matters worse"—the Administration should solidly resist proposals that would require Environmental Impact Statements on U.S. exports or on Export-Import Bank projects in foreign lands. Our foreign customers don't need us to tell them whether they may drain a swamp or build a power plant. And the delays would be utterly disastrous in negotiations to win export orders.

STRONG DOMESTIC PROGRAM

Still another plank in our foreign economic policy should be a strong domestic program to keep American industry competitive.

Our industrial machine is overage and ofttimes noncompetitive, as the steel industry can tell you. The tax structure must be changed to encourage business to modernize and invest in new technology. The Administration's proposal to cut the corporate tax rate from 48 percent to 44 percent over the next two years, and to liberalize the investment tax credit, is a step in the right direction. But more is needed in the years ahead to offset the destructive effects of inflation and improve the climate for investment.

The government should also encourage more direct foreign investment in the United States. This would not only help solve our capital formation problem, but also strengthen the dollar by reducing our balance of payments deficit. Specifically, we should devise a policy of partial tax integration that will benefit foreign as well as domestic investors, and avoid the kinds of regulatory rigidities that are disincentives to investment anywhere.

We also need encouragement for a higher level of research and development on commercially viable technologies, to help retain this country's technological lead—still our main advantage, but one that is fading fast.

Since oil imports are such a large part of the trade and dollar problem, we obviously need a realistic energy program that will develop our own domestic energy resources and reduce our dependence on foreign oil.

And finally, we need a much more determined effort to bring inflation under control. The decline of the dollar is not going to stop until the world is convinced that we're ready to stabilize the value of the dollar at home. As *Business Week* said in an editorial on April 10, 1978: "No Administration has ever talked more convincingly about the necessity for stabilizing prices and protecting investors. And no Administration has so casually ignored these goals when it got down to the hard choices of policymaking."

It's going to take political courage to veto inflation bills and hold a firm ceiling on government spending in an election year, but this—rather than jawboning—is the real key to the control of inflation and the defense of the dollar.

PRIORITIES

Foreign economic policy is only one item on the national agenda, and perhaps the Administration has other priorities. But it seems to me that there is so much at stake here—not only the strength of our own economy, but also the stability of the world economy and the character of our relationships with other nations of the world—that the Administration might well want to give this problem a higher priority than it has enjoyed thus far.

That would clearly be in the public interest, and who knows—it might be good politics, too!

[From the New York Times, June 13, 1979]

WEST'S INFLATION RATE FOUND ACCELERATING

(By Paul Lewis)

Paris, June 12—Inflation is starting to accelerate again throughout the Western industrial world, arousing fears that another economic slowdown with higher unemployment may lie ahead.

The Organization for Economic Cooperation and Development, which monitors the economic performance of the world's leading non-Communist industrialized

nations, announced today that consumer prices rose 1.1 percent on average in its 24 member countries during April—the sharpest monthly increase in two years.

GROWTH RATES EXPECTED TO FALL

Tomorrow, the O.E.C.D.'s Secretary General, Emile van Lennep, plans to warn the organization's annual ministerial meeting that rising inflation is likely to depress the West's overall economic growth rates to between 3 and 3.5 percent this year from the 3.7 percent level achieved in 1977 and 1978.

WORLD INFLATION

[All figures are percentages at annual rates for consumer price indexes]

	Average 1961-70	Average 1971-76	1977	1978	6 months to April 1979
United States	2.8	6.6	6.5	7.7	10.8
Japan	5.8	11.1	8.1	3.8	1.4
West Germany	2.7	5.9	3.9	2.6	7.3
France	4.0	8.9	9.4	9.1	9.3
Britain	4.1	13.6	15.9	8.3	13.5
Canada	2.7	7.4	8.0	9.0	9.8
Italy	3.9	12.2	17.0	12.1	15.6
O.E.C.D.	3.4	8.6	8.7	7.9	9.3

Source: Organization for Economic Cooperation and Development

"Resilient inflation may make it impossible to increase economic demand in a number of countries over a longish period," Mr van Lennep said at a preconference news briefing today.

Although unemployment now stands at 18 million, or 5.4 percent of the O.E.C.D. countries' combined workforce, Mr. van Lennep warned that growth "is likely to remain too weak to bring about any reduction over the next 18 months."

PRICE INCREASES ACCELERATING

April's big rise in retail prices throughout the Western world brings the average increase in the O.E.C.D. area to an annual rate of 8.7 percent so far this year.

But the April rise also means that the rate at which consumer prices are rising is starting to accelerate sharply. Over the six-month period ended in April, the O.E.C.D. reports, retail prices rose at an annual rate of 9.3 percent, "a sharp increase" over the 8.4 percent rate recorded during the six months ended in March.

The overall average is pushed up by rapidly rising prices in the United States, which is the largest economy in the O.E.C.D. area. But, with the significant exception of Japan, prices are also accelerating in all other important Western industrial countries.

If prices continue to rise at comparable rates during the remainder of this year, the O.E.C.D.'s figures show that the Western world will have lost the gains it has made against inflation last year and could be heading for its worst inflationary performance in recent history.

FEAR OF RESTRICTIVE POLICIES

Between 1961 and 1970, the O.E.C.D. calculates that consumer prices rose at an overall average annual rate of 3.4 percent. The rate accelerated sharply between 1971 and 1976 to 8.6 percent, edged up to 8.7 percent the following year and then fell nearly a percentage point to 7.9 percent in 1978. Now it is on the rise again.

This surge in inflation is already arousing anxiety among economic-policy makers, who fear that sharply rising prices will force governments to adopt restrictive policies that will undermine the hesitant economic recovery now under way in several Western countries.

Such fears are reinforced by the growth of inflation in those countries where it traditionally has been lowest, leading the rest of the world to rely upon them to sustain trade and growth by keeping their economies reasonably buoyant.

JAPAN'S INFLATION RATE FELL

The United States, where prices rose an average 2.8 percent a year between 1961 and 1970, had the third-highest inflation rate among the major O.E.C.D. countries in the six months ended in April, with prices rising at an annual rate of 10.8 percent, a performance exceeded only by Britain (13.5 percent) and Italy (15.6 percent).

In West Gernmany, inflation was running at a 7.5 percent annual rate in the six months ended in April, or almost three times the 2.6 percent rate recorded in 1978. Swiss inflation is accelerating even more sharply—it reached 5.4 percent in the six months to April, compared with only 1.1 percent in 1978 as a whole. The major exception among non-Communist industrialized countries is Japan, where inflation in the six months ended in April fell to 1.4 percent from 3.8 percent in 1978 as a whole.

The United States team at the O.E.C.D. meeting is headed by W. Michael Blumenthal, Treasury Secretary, Warren Christopher, Deputy Secretary of State, and Richard N. Cooper, Under Secretary of State for Economics.

U.S. URGED TO SLOW ECONOMY

Earlier this week, the Bank for International Settlements, noting that West Germany was already raising interest rates, said a quick slowdown in America's economy now offered the best way to curb inflationary pressures and prevent a general return to austerity throughout the West that could tip the world into "a major recession."

Economists at the O.E.C.D. and elsewhere generally agree that the current surge in inflation has multiple, if sometimes contradictory, causes, although they argue over their relative significance.

An important, although paradoxical, explanation is that last year the weak dollar reduced the cost of oil and other imported raw materials for Europe and Japan, which pay for them in dollars. Now that the dollar is stronger, these countries find their import bills rising again and have to face the awkward fact that even their present depressed levels of econcmic activity may be incompatible with the level of inflation they want.

MONEY SUPPLIES EXPANDING

This is why West Germany is now trying to prevent the dollar from rising too far against the mark, although last year it was trying to prop up the dollar, arguing that a weak dollar would undermine world trade.

But while the weak dollar helped Europe dampen raw material costs, it fueled inflation in the United States by increasing the cost of many American imports.

A second factor is that a strong United States recovery, combined with Europe's more modest upswing, has pushed up raw material prices, while the Iranian crisis has caused oil prices to start rising faster than world inflation after several years during which its real cost fell.

Finally, Europe's efforts last year to prop up the dollar in the foreign-exchange markets led to a big inflow of funds that expanded national money supplies and gave a further push to prices.

[By direction of the chairman the following communications were made a part of the hearing record:]

PULLMAN, INC.,
Washington, D.C., June 11, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We applaud your initiatives to give full view to the United States' plight as an exporting nation. The hearing which you will chair on June 18 and which will focus on legislation proposed to ease our difficulties is particularly laudable, we believe. While these bills are rooted conceptually in possible domestic initiatives, we are drawn by the title of your hearings: export incentives. For it is inescapable, in our judgment, to consider export initiatives without, at some point, deliberating on the issue of foreign tax credits. As you no doubt know, there is heightening controversy over this issue, some of it innocent of total background and understanding of the issue. That is why I am writing to you: to seek your guidance as to including this issue in your June 18 hearing.

Two sections of the code are potentially most harmful to the ability of U.S. firms to compete effectively overseas. Under Section 901 of the Internal Revenue Code, American companies doing business overseas are entitled to credit income taxes paid to foreign countries against their United States Federal income tax. In addition, under Section 903 of the Code, such companies may credit taxes imposed by foreign countries "in lieu of" an income tax.

Many foreign countries impose a tax on gross income received from professional and technical services. Pullman and other American engineering and construction companies working overseas are frequently subject to such a tax. Applicable United States court decisions indicate that a foreign gross income tax is creditable against federal income tax as long as the gross income tax is highly likely or reasonably intended to reach net gain.

The Internal Revenue Service, however, in a 1978 tax ruling indicated essentially that unless a gross income tax expressly provides for deduction of expenses it will not be creditable. In this and other recent rulings, the Internal Revenue Service appears to be insisting that unless a foreign tax is virtually the "mirror image" of the United States federal income tax it will not be creditable. This position is unrealistic, and it has put in issue the creditability of many of the taxes to which American engineering and construction firms are overseas.

At the same time, the possible alternative of relying on Section 903's provision for taxes imposed "in lieu" of income taxes has been seriously undercut by long-standing regulations of the Internal Revenue Service. The legislative history of Section 903 reflects that Congress intended that where a country imposes a gross income tax in a situation where it is not imposing its regular income tax, the former should generally be creditable as an "in lieu" tax. The Internal Revenue Service regulations, however, take a narrower position to the effect that a tax will be creditable as an "in lieu" tax only where it can be shown that the foreign country has expressly substituted that tax for a general income tax which would have otherwise been applicable. To find express evidence of such a purpose on the part of a foreign country is extremely difficult.

American has fallen in the last several years from first to fourth in the world in annual volume of construction business overseas. While this is presumably due to a variety of factors, certainly the position of the Internal Revenue Service on the availability of the foreign tax credit has been injurious. Not only does it fail to carry out the basic purpose of the foreign tax credit—to preclude double tax liability—but it affirmatively places an unwarranted roadblock in the paths of many American construction firms seeking contracts throughout the world.

The Treasury Department and the Internal Revenue Service are currently conducting a regulations project with respect to both Sections 901 and 903. It is expected that proposed regulations will be published this summer, although no time schedule has been announced. These regulations could overcome, or at least substantially alleviate, the problem that has been described by either (1) providing in the regulations under Section 901 that gross income taxes will be creditable where they are highly likely, or reasonably intended, to reach net income (a standard drawn from applicable case law), or (2) providing in the regulations under Section 903 that gross income taxes will be deemed creditable "in lieu" taxes where the income on which they are imposed is not also subject to regular income tax and where that income would be taxable under United States income tax laws if earned here by a foreign company.

Such regulatory provisions, however, are by no means assured. A more certain, effective and perhaps appropriate remedy might be found in the Congress, either through specific amendments to the Code or creation of legislative history through hearings.

I would welcome, and be most grateful for, your counsel on these very important matters.

Sincerely,

KATE CLARKE.

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION, SUBMITTED BY LAT H. TURNER, CHAIRMAN, TAXATION COMMITTEE

The National Cattlemen's Association is the national spokesman for all segments of the Nation's beef industry—including cattle breeders, producers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 13 affiliated national breed organizations.

SUMMARY

The National Cattlemen's Association supports the purpose and provisions of S. 231 and S. 935, both of which would be particularly beneficial to cattle operations as well as to other agricultural and non-agricultural businesses. Both of these bills would help increase this nation's productivity by encouraging investment in essential business property and equipment and should help reduce the current rapid rate of inflation.

The National Cattlemen's Association urges passage of both S. 231 and S. 935.

STATEMENT

S. 231

The general impact of this bill would be to allow taxpayers larger depreciation deductions in taxable years beginning after December 31, 1978. This would be accomplished as follows: The variation from class lives by 30 percent instead of the present 20 percent; the ability to desdregard salvage value in computing allowable depreciation; and permitting simplified depreciation and shorter lives for certain small business property. All of these modifications would be extremely beneficial to business in general and to cattle operations and Agriculture in particular. Since cattle and agricultural operations are highly capital intensive, permitting larger depreciation deductions would be most helpful.

Perhaps the most favorable of these modifications would be the ability to disregard salvage value in computing depreciation. For example, Section 167(f) of the Internal Revenue Code presently allows salvage value to be reduced by up to 10 percent of the basis of personal property, other than livestock, which has a useful life of three years of more. There is no justification to retain this exclusionary rule for livestock under Section 167(f) expecially since depreciable livestock is now subject to the depreciation recapture rules of Section 1245. S. 231 properly removes this salvage value limitation rule with regard to taxpayers using the Class Life System of depreciation.

By permitting small businesses (i.e. those with an adjusted tax basis in assets [other than real property] of $250,000 or less) to use a simplified but shortened straight line depreciation table, significant benefits will be achieved and production by these small businesses encouraged. The depreciable lives of 5 years for farming asssets (compared to an average of 10 years under the Class Life System) and 12 years for farm buildings (compared to 25 years under the Class Life System) would be particularly advantageous to cattlemen and others engaged in agricultural pursuits.

S. 935

Except for elevators, single purpose agricultural structures and qualified rehabilitation facilities, this bill would permit depreciable property which qualifies for the investment tax credit to be depreciated over a useful life of 5 years. Since this would be an elective provision, taxpayers could decide whether the shorter period of depreciation would be advantageous, considering that fact that if it were elected the bonus first year depreciation which applies to tangible personal property with a useful life of 6 years of more would not be available.

Since pollution control facilities are becoming more commonplace in the cattle business and in Agriculture in general, the provisions of this bill which would reduce the amortization period of such facilities from 60 to 24 months and repeal the amount of such amortization which is currently treated as a tax preference subject to the minimum tax would be most beneficial.

PAUL H. DELANEY, Jr.,
Washington, D.C., July 6, 1979.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, Subcommittee on Taxation and Debt Management, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to the Press Release of the Subcommittee on Taxation and Debt Management, Committee on Finance, United States Senate (sometimes hereinafter referred to as the "Subcommittee"), of May 17, 1979, regarding the Subcommittee's public hearing on tax incentives for exports.

The purpose of this letter and the attached materials submitted on behalf of Cargill Incorporated is to provide Members and staff of the Subcommittee with our comments and recommendations regarding needed changes in United States taxation of foreign source income and related matters with particular reference to the

linkage of tax and trade issues and the need for legislative changes in the context of the Tokyo Round of multilateral trade negotiations ("MTN") and related international proceedings to preserve the competitive position of United States firms engaged in international trading of agricultural commodities.

We wish to thank the Members of the Subcommittee for their continuing efforts to provide representatives of the private sector an opportunity to express views on international tax and trade matters. We are particularly concerned about the need for timely changes regarding United States taxation of foreign source income in the context of the MTN agreements and related international trade proceedings. Previous materials concerning certain of these issues were provided to the House Ways and Means Committee and the Senate Finance Committee during years 1975 through 1978.

In accordance with recent international tax and trade developments, including the MTN, with particular reference to the Subsidies and Countervailing Duty Code, the November 1976 Panel Decisions under the auspices of the General Agreement of Tariffs and Trade on certain tax practices of the United States, France, Belgium and the Netherlands, and various proceedings and deliberations of the House Ways and Means Committee and the Senate Finance Committee, we urge the United States Congress, and more specifically the Members of the House Ways and Means Committee and the Senate Finance Committee, to adopt necessary changes in United States federal income tax law to place United States owned firms engaged in international trading of agricultural commodities on a substantially equivalent tax footing with their foreign owned competitors.

Again, we wish to express our appreciation to the Members and staff of the Subcommittee, and we urge the Congress to proceed, as expeditiously as possible, with the necessary legislative changes to preserve and improve the competitive position of United States firms engaged in international trading of agricultural commodities in an effort to reduce the continuing and substantial United States trade deficit with other trading nations.

Respectfully submitted.

PAUL H. DELANEY, Jr.

Enclosure.

COMMENTS AND RECOMMENDATIONS REGARDING U.S. TAXATION OF FOREIGN SOURCE INCOME AND RELATED MATTERS

Introduction

The purpose of this memorandum is to recommend needed changes in United States taxation of foreign source income in the context of the Tokyo Round of Multilateral trade negotiations ("MTN") and related international proceedings to preserve the competitive position of United States firms engaged in international trading of agricultural commodities. The proposed changes have important international trade implications, and recent developments suggest the timeliness of making these changes during Congressional consideration of the Trade Agreements Act of 1979 and the implementation of the MTN international agreements.

In accordance with recent international tax and trade developments, including the MTN, with particular reference to the Subsidies and Countervailing Duty Code ("Subsidies Code"), the November 1976 Panel Decisions under the auspices of the General Agreement on Tariffs and Trade ("GATT") on certain tax practices of the United States, France, Belgium and the Netherlands ("GATT Panel Decisions"), and various proceedings and deliberations of the House Ways and Means Committee and the Senate Finance Committee, it is urged that the United States Congress, and more specifically the members of the House Ways and Means Committee and the Senate Finance Committee, adopt necessary changes in the United States federal income tax law to place United States owned firms engaged in international trading of agricultural commodities on a substantially equivalent tax footing with their foreign owned competitors.

Subpart F was added to the United States Internal Revenue Code under the provisions of the Revenue Act of 1962. Its effect is to tax on a current basis the undistributed earnings and profits of United States owned foreign based trading companies (controlled foreign corporations). Before 1962 such income was taxed like income of other foreign corporations, only when it was repatriated to the United States. The effect of Subpart F has been to discourage the formation and operation of United States owned foreign based trading companies by placing them at a significant disadvantage in their competition with foreign owned trading companies. No other major trading nation taxes such income of international trading companies prior to repatriation, and in point of fact, many countries do not tax this

income at all. Instead, recognizing the value of such trading companies in expanding domestic exports, most nations have actively encouraged and supported the formation and growth of such companies. Japanese and European international trading companies have been especially successful in exploiting opportunities in world markets.

It is understandable that international trade considerations played so limited a part in the discussions and considerations which led to Subpart F in 1962. At that time, the United States was still the dominant world economic power, with large year-to-year surpluses on trade account. These circumstances have changed in recent years. The United States position in world trade has deteriorated as other nations have emerged as strong competitiors. Consistent United States surpluses have given way to large deficits. There is a growing concensus that steps must now be taken to increase United States competitiveness in all international markets.

Notwithstanding the enactment of Subpart F in 1962, several United States based international trading companies were able to continue operations under significant exceptions and escape valves which the Congress included as a part of Subpart F. These firms have played a major role in the rapid expansion of United States farm exports in the past 15 years.

Further amendments to the Internal Revenue Code enacted in 1975 have eliminated or drastically reduced the scope of these exceptions. The effect has been to undermine the competitive position of United States international agricultural trading firms. These firms cannot absorb the tax disadvantages imposed by amended Subpart F as they possess no unique advantages such as established brand franchises or product superiority. The products which these United States international trading firms offer, raw or semi-processed agricultural commodities, are the same products offered by their foreign owned competitors; these products are acquired from the same sources and sold to the same ultimate customers. Traditionally low margins in this commerce offer limited, if any, opportunity for absorbing significant cost disadvantages.

United States owned international trading firms faced with this reality have two choices: they can slowly surrender their business to foreign owned trading firms not subject to United States tax jurisdiction and control, or they can share (or give up) control of their foreign based international trading operations with foreign interests not subject to United States tax jurisdiction and control. In either event, the United States loses in this process. First, the United States is surrendering important advantages in world trade. While foreign based trading companies typically trade in farm commodities from all origins, United States owned firms gain most from sales of United States commodities because such firms maintain large capital investments in facilities which can be used only in originating commodities produced in the United States. Active participation in all world markets by United States firms assures that in any negotiation involving agricultural products, United States interests in selling are actively represented. Sharing of ownership and control of these firms with foreign interests (or surrendering control to such interests) will dilute the primary interest of the United States firms in selling United States commodities in the world resellers market. Second, to the extent this activity passes beyond United States tax jurisdiction and control, the United States loses the opportunity to tax the earnings and profits derived from this international commerce when such income is subsequently repatriated to the United States.

More recently, based in large part on these changes in economic circumstances, the United States Congress has become increasingly concerned about the declining position of United States firms in international trading markets, and the Congress has indicated a willingness to proceed with necessary changes in United States law including United States tax law, to enable United States firms to be more competitive in world markets.

As a consequence of the major differences in the historical evolution of United States tax law as it impacts on international trading activity and the tax laws of other major trading nations of the world as they impact on international trading activity, it is not surprising that there are generally no United States counterparts to the Japanese trading companies or other foreign based international trading companies, although certain United States firms do participate in international agricultural commodities trade. Furthermore, foreign based international trading companies have played a major role in expanding the trade of other nations which compete with the United States. Nations such as Japan, West Germany, and the Netherlands have placed the highest priority on international trade considerations and have provided substantial incentives to trading firms located within their borders. If the United States is to be competitive in international trading markets,

it must also develop policies and provide incentives directed towards encouraging international trading activity by United States based firms.

The substantial emphasis directed to international trading activities by most of the major trading nations is clearly demonstrated by the tax systems adopted by such countries designed to stimulate their exports and international trading activities. More particularly, the territorial system of taxation utilized by most of these countries clearly places United States based firms at a competitive tax disadvantage in competing for world markets.

Although the Congress has recognized this problem and the importance of providing necessary incentives to United States firms, it has yet to enact changes in United States tax law needed to accomplish this objective. The proposed exception to Subpart F for income from international trading in agricultural commodities is designed specifically to encourage further expansion of agricultural trade by placing United States owned international trading companies on a more equal tax footing with their foreign owned competitors which are beyond United States tax jurisdiction and control.

Several recent events suggest the importance and timeliness of Congressional action on this issue now:

(1) Both the House Ways and Means Committee and the Senate Finance Committee have recognized that application of Subpart F to United States owned firms engaged in trading of agriculture commodities reduces their competitiveness and their ability to market United States agricultural products abroad effectively;

(2) The provisions of the Trade Act of 1974 and various statements by Congressional Committees recognize that taxes play an important role in trade and that present arrangements favor exports of other nations;

(3) Despite the decisions by GATT panels that the tax practices of certain European countries which are designed to stimulate exports and international trading activities, the United States has not been able to secure changes in these practices;

(4) United States trade negotiators have been unsuccessful in the Tokyo Round of multilateral trade negotiations in obtaining concessions or agreement from other major trading nations regarding the impact taxes on international trade under the provisions of the Subsidies Countervailing Duty Code;

(5) Findings and determinations of the House Ways and Means Committee and the Senate Finance Committee suggest that United States based firms are now operating at a competitive tax disadvantage relative to their foreign based competitors;

(6) In seeking broad agreement with the other leading trading nations of the world, United States negotiating efforts directed towards obtaining international rules to assure tax equity and fairness are strengthened by placing United States based companies on a similar tax footing with their foreign based competitors as it is clear that so long as others enjoy advantages in world trade under present arrangements they have little incentive to enter into negotiations designed to create equality in the tax treatment of firms involved in international trade.

This memorandum proposes that the United States Congress amend the provisions of the Internal Revenue Code to exclude from current taxation, under Subpart F, income derived from international sales of agricultural commodities. This would expand the concept already accepted by the Congress and embodied in the present limited agricultural commodities exception to Subpart F. Furthermore, both the House Ways and Means Committee and the Senate Finance Committee have previously agreed on an expanded version of this agriculture commodities exception.

Adoption of this amendment in the context of Congressional consideration of the Trade Agreements Act of 1979 and implementation of the MTN international agreements would assure that United States firms could compete more effectively in international trading markets for agricultural commodities and would also provide needed leverage for meaningful international discussions designed to achieve equity in the tax treatment of all international trading enterprises.

Discussion

U.S. TAXATION OF FOREIGN SOURCE INCOME

Tax jurisdiction and taxation of foreign source income

A particular nation may tax the worldwide income of its nationals, restrict the scope of its tax jurisdiction to a territorial basis (tax only domestic source income), or provide for other means of limiting the taxation of foreign source income.

In response to a United States Congressional inquiry in March 1973, a study was prepared under the auspices of the Council on International Economic Policy

("CIEP") regarding tax treatment by other nations of their own multinational firms (taxation of foreign source income).[1]

This study summarized the basic rules of the following countries with respect to taxation of foreign source income: Belgium, Brazil, Canada, Denmark, France, Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Norway, Switzerland, and the United Kingdom.

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide, territorial, and varied forms of exemptions and credits), not one of the nations considered in the CIEP study taxed currently the undistributed profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that The United States taxes undistributed profits of United States controlled foreign corporations on a current basis, this places United States based companies engaged in international operations at a competitive disadvantage and constitutes a departure from the general scheme of international taxation practiced by other nations.

U.S. tax jurisdiction

United States federal tax jurisdiction is based on two general principles:[2]

(1) Nationality, under which the United States taxes worldwide income of "United States persons";[3] and

(2) Source of income, under which the United States taxes "United States source income" of United States persons and "foreign persons," including "nonresident aliens" and "foreign corporations" (in limited circumstances, the United States taxes "foreign source income" of foreign persons "effectively connected with a United States trade or business").

The term "United States person" includes United States domestic corporations.[4]

U.S taxation of U.S. corporations and foreign corporations

As noted above, the United States tax jurisdiction is based on both nationality and source of income. The United States taxes United States persons (citizens, residents, corporations, partnerships, trusts, etc.) on income from all sources.

The modern United States corporate income tax dates from 1909. At that time, domestic corporations were taxed on income from all sources and foreign corporations on income from business transacted and capital invested within the United States. This jurisdictional pattern remained substantially unchanged until 1962.

The impact of tax on the foreign source income of United States persons was softened somewhat in 1918 with the adoption of a foreign tax credit. Previously, foreign taxes had merely been deductible, like state and local taxes. The credit can apply to both the earnings and profits of foreign subsidiary corporations and foreign branches. Only payments treated as income taxes, or "in lieu of income taxes", qualify for the credit.[5]

The income of foreign corporations, if derived from business conducted outside the United States, is generally not subject to current United States income taxation.

In broad terms, a corporation is treated as a United States domestic corporation if it is incorporated in any of the states of the United States or the District of Columbia and is treated as a foreign corporation if it derives its charter from a foreign government.

Foreign source income earned by a foreign corporation controlled by United States persons is generally exempt from United States taxation until distributed to shareholders who are United States persons.[6] The effect of these provisions of the Internal Revenue Code is that a United States person (United States shareholder) is allowed to defer paying the United States income tax on undistributed earnings and profits of a controlled foreign subsidiary corporation until such earnings and profits are repatriated to the United States (this development is often referred to as "deferral" of tax with respect to foreign investment).

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[1] See information submitted for the record by the Council on International Economic Policy to the Subcommittee on International Trade, Senate Finance Committee, Hearings on Multinational Enterprises, February 26 through March 6, 1973.

[2] See Internal Revenue Code of 1954, as amended, Title 26 U.S.C. §§ 1 and 11(a) (sometimes hereinafter referred to as the "I.R.C.") which set forth very broad jurisdictional rules imposing tax on the taxable income of "every individual" and "every corporation," respectively.

[3] The term "United States person" and other relevant terms pertaining to United States tax jurisdiction are defined and discussed subsequently in this memorandum.

[4] I.R.C. 7701(a)(30) defines "United States person" to include citizens, residents, domestic partnerships, domestic corporations, and domestic estates and trusts.

[5] See I.R.C §§ 901-906.

[6] See I.R.C. §§ 1, 11, 861-864, 881-883, and 1201.

A corporation receiving a dividend from a controlled United States domestic corporation is generally entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax.[7] Dividends from a foreign corporation are not entitled to this exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals.[8] Therefore, United States shareholders of foreign corporations are generally taxed fully on dividends received from foreign corporations.

A United States corporation which in any taxable year owns at least 10 percent of the voting stock of a foreign corporation from which it received dividends is entitled to a foreign tax credit for income taxes paid by that foreign corporation.[9]

Current taxation of undistributed earnings and profits of foreign corporations

Although United States shareholders (United States persons) of foreign corporations are generally not subject to United States tax on the income of such foreign corporations unles, and until, such income is repatriated to the United States in the form of dividends (or remittances in the nature of a dividend), United States shareholders of two categories of foreign corporations are effectively subject to current United States taxation on certain types of undistributed income:

(1) "Foreign personal holding companies"; and

(2) "Controlled foreign corporations."

U.S. taxation of controlled foreign corporations under subpart F

In accordance with the provisions of the Revenue Act of 1962,[10] the United States Congress added Subpart F to the Internal Revenue Code in an effort to deal with the problem of tax haven operations.[11] Under this approach, United States shareholders of controlled foreign corporations ("CFCs") are subject to current United States income taxation on certain forms of undistributed tainted income (tax haven or Subpart F income):

(1) Subpart F income, including foreign base company income and income derived from insurance of United States risks;

(2) Previously untaxed Subpart F income withdrawn from investment in less developed countries; and

(3) Any increase in investment in United States property to the extent it would be taxable as a dividend if distributed to United States shareholders.

It should be understood that Subpart F taxes United States shareholders not on their own income, but on the income of CFCs in which they own an interest. This development relates to the consideration that there may be no jurisdictional basis for taxing a foreign corporation unless it earns income from sources within the country asserting jurisdiction to tax (or has income effectively connected with business operations in such country). Therefore, Subpart F jurisdiction is predicated on United States citizenship or residence, rather than source of income.

Recent Legislative History of United States Taxation of Foreign Source Income Including International Trading Income.

1973 and 1974 tax proceedings

In January 1973, the Chairman of the House Ways and Means Committee, announced that extensive public hearings would be held on tax reform, specifically noting taxation of foreign income.

In November 1974, pursuant to tentative decisions on tax reform proposals, the House Ways and Means Committee agreed to modify the definition of foreign base company sales income to exclude income arising from the sale of goods manufactured abroad. This change was reflected in a bill entitled, the "Energy Tax and Individual Relief Act of 1974", introduced by Congressman Mills and referred to the Committee on Ways and Means.[12]

The Report of the House Ways and Means Committee accompanying the "Energy Tax and Individual Relief Act of 1974" provided an explanation of the Committee's reasons for this contemplated change in the definition of foreign base company sales income: [13] "Your committee's bill changes the definition of foreign base company sales income (i.e., what sales income constitutes tax haven income) to exclude sales

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[7] See I.R.C. § 243.

[8] See I.R.C. §§ 243.

[9] See I.R.C. §§ 902.

[10] See Revenue act of 1962, P.L. 87-834, H.R. 10650, 87th Cong. 2d Sess., 76 Stat. 960, October 16, 1962.

[11] See I.R.C. § 951(a)(1).

[12] See § 332, Energy Tax and Individual Relief Act of 1974, H.R. 17488, 93rd Cong. 2d Sess., November 21, 1974.

[13] See Report of House Ways and Means Committee accompanying H.R. 17488, pp. 313 and 132, H. Rep. No. 93-1502, 83rd Cong. 2d Sess., November 26, 1974.

income from goods manufactured, produced, grown, or extracted outside of the United States."

Tax Reduction Act of 1975

In March 1975, the President of the United States signed the Tax Reduction Act of 1975 (sometimes hereinafter referred to as the "TRA"), thus providing for several significant modifications concerning United States taxation of foreign source income: [14]

(1) The so-called "30-70" "safe haven" or "shielding" rules which had applied to CFC's where foreign based company income constitutes less than 30 percent of gross income were amended to reduce the relevant threshold test to less than 10 percent;

(2) The minimum distribution exception to current taxation of Subpart F income was terminated;

(3) The exlusion for certain foreign personal holding company income reinvested in less developed countries was eliminated; and,

(4) The exception for foreign base company shipping income was limited to income reinvested in shipping operations.

The relevant House bill had contained no provisions amending United States rules for CFC's and their United States shareholders.[15] Nor did the Senate Finance Committee recommend changes in this area of United States tax law.[16] Nevertheless, prusuant to amendments voted on the floor of the Senate, it was provided that United States persons holding a one percent or greater interest in a foreign corporation would be taxed currently on their proportionate share of the income from such a corporation in cases where more than 50 percent of the stock of the corporation was controlled by United States persons.

The House and Senate conferees adopted a compromise approach which did not eliminate deferral across-the-board, but rather expanded on the Subpart F approach to tax specific categories of income on a current basis: [17]

"The conference substitute provides for a number of specific measures which substantially expand the extent to which foreign subsidiaries of U.S. corporations are subject to current U.S. taxation on tax haven types of income under the so-called Subpart F rules of the Code.

"The conference substitute repeals the minimum distribution exception to the Subpart F rules which, under present law, permits a deferral of U.S. taxation on tax haven types of income in cases where the foreign corporation (or various combinations of foreign-related corporations) distributed certain minimum dividends to their U.S. shareholders. The effect of repealing this exception is to tax currently all income of foreign subsidiaries of U.S. corporations which is deemed to be tax haven income under the existing so-called Subpart F rules of the Code. An exception to this provision was made for agricultural commodities not produced in commercially marketable quantities in the United States. Under the exception, these commodities grown (or raised) abroad are to be excluded from foreign base company sales income."

It was noted at the time of conference, that unless an agricultural commodites exception was adopted, the competitive position of the United States owned firms participating in international agricultural commodities trade would be undermined with the result that this important business would be transferred to foreign owned firms beyond United States tax jurisdiction and control and that this would be contrary to important United States national and international interests.

It was recognized that under United States tax law, United States owned firms had for many years competed on an equal tax footing with foreign owned firms in world agricultural trade. As a result United States owned firms were involved in a significant portion of this trade. However, if United States owned firms were required to pay taxes on a current basis they could not compete in this market, as they possess no special advantages such as technology or established brand names, that would enable them to absorb such a significant tax disadvantage. United States firms buy and sell the same commodities as their foreign owned competitors. No other country in the world taxes earnings on this trade on a current basis.

Following enactment of the Tax Reduction Act of 1975, it was recognized that certain ambiguity was inherent in language chosen to create the new agricultural commodities exception.

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[14] See § 602, Tax Reduction Act of 1975, Public Law 94-12, H.R. 2166, 94th Cong. 1st Sess., 89 Stat. 58, March 29, 1975.

[15] See Tax Reduction Act of 1975, H.R. 2166, 94th Cong. 1st Sess., March 17, 1975.

[16] See Report of the Senate Finance Committee accompanying H.R. 2166, Sen. Rep. No. 94-36, 94th Cong. 1st Sess., March 17, 1975.

[17] See Conference Report accompanying H.R. 2166, p. 70, Rep. No. 94-120, 94th Cong. 1st Sess., March 26, 1975.

Tax Reform Act of 1975

The issue of the agricultural exception was raised again during proceedings of the House Ways and Means Committee in late 1975.[18] The consensus was that a technical amendment was probably incorporated in the 1975 House Bill to accomplish this purpose, provided:[19]

"(a) In General.—The last sentence of paragraph (1) of section 954(d) (relating to definition of foreign based company sales income) is amended to read as follows: 'For purposes of this subsection, personal property does not include agricultural commodities which are significantly different in grade or type from and are determined by Secretary of the Treasury after consultation with the Secretary of Agriculture not to be readily substitutable for (taking into account consumer preferences) agricultural products grown in the United States in commercially marketable quantities.' "

The House Ways and Means Committee advanced the following arguments in support of revising the language of the Tax Reduction Act of 1975: [20] "* * * One of the categories of tax haven income subject to current taxation under the Subpart F provisions of the coded is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to your committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of a different grade or variety from the same product grown in the United States. Your committee believes that sales of foreign-grown agricultural products which are not readily substitutable for U.S.-grown agricultural products should not be included within the definition of foreign base company sales income in the case of sales made to third countries. *Your committee is aware that these sales are highly competitive and that if the profits on these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies would have difficulty competing with foreign-controlled companies. Accordingly, your committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.*" [Emphasis supplied.]

Notwithstanding the clear concern of the House Ways and Means Committee that the United States owned companies be given a continuing opportunity to compete for this important business, it was recognized that substantial complexity might be involved in interpreting this language as a consequence of inherently difficult constructions.

Tax Reform Act of 1976

In early December 1975, the full House passed the Tax Reform Act of 1975, H.R. 10612, and referred the bill to the Senate. Because of time constraints and other considerations, the Senate Finance Committee directed its immediate attention to the tax reduction provisions of the 1975 House bill and did not undertake consideration of the tax reform provisions of the bill.

During the month of December 1975, the House and Senate debated and acted on this legislation and then forwarded a bill to the President to extend tax reductions until June 30, 1976. The tax reform provisions of the 1975 House bill, including the provisions modifying the agricultural exception to Subpart F, were not considered by the Senate Finance Committee in 1975.

In February 1976, the Chairman of the Senate Finance Committee announced that the Committee would begin hearings in March 1976 on major tax revision proposals and extension of expiring tax cut provisions. Following these hearings, the Senate Finance Committee proceeded with mark-up of the subject tax legislation and reported out a bill for consideration of the full Senate in June 1976.[21]

Based on considerations noted above, the Senate Finance Committee initially adopted an agricultural commodities exception based on the third market country approach: [22]

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[18] See Committee Print prepared for the use of the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation concerning U.S. Taxation of Foreign Source Income, p. 8, September 27, 1975.

[19] See Section 1025 of the Tax Reform Act of 1975 (concerning limitation on definition of foreign base company sales income in the case of certain agricultural products), H.R. 10612, p. 211 and 212, Rep. No. 94—658, 94th Cong., 1st Sess., November 12, 1975.

[20] See Report of the House Ways and Means Committee accompanying H.R. 10612, p. 221, Rep. No. 94-658, 94th Cong., 1st Sess., November 12, 1975.

[21] See Report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., June 10, 1976.

[22] See H.R. 10612, Rep. No. 94-938, 94th Cong., 2d Sess., p. 471, June 10, 1976.

"Sec. 1025. Limitation on Definition of Foreign Base Company Sales Income in the Case of Certain Agricultural Products.

(a) In General.—The last sentence of paragraph (10) of section 954(d) (relating to definition of foreign base company sales income) is amended to read as follows: 'For purposes of this subsection, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States.' "

This approach provided a clear and easily administered standard which would enable United States owned firms to compete for this important third country trade without significant doubts about the tax consequences under United States laws.

The following reasons for adopting this approach were noted in the Senate Finance Committee report.[23]

"Certain agricultural products

Reasons for change: As indicated above, one of the categories of tax haven income subject to current taxation under the Subpart F provisions of the code is base company sales income. The Tax Reduction Act of 1975 contained an amendment which provides that base company sales income does not include the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities. It has come to the committee's attention that questions have been raised as to the extent that this exclusion applies to agricultural products which are of different grade or variety from the same product grown in the United States. The committee believes that sales of foreign-grown agricultural products for use, consumption, or disposition outside the United States should not be included within the definition of foreign base company sales income. *The committee is award that these sales are highly competitive and that if the profits on these sales were subject to U.S. tax on a current basis, U.S.-controlled foreign companies could have difficulty competing with foreign-controlled companies. Accordingly, the committee believes it is appropriate to permit this category of income to retain the tax advantages of deferral until the profits are repatriated to the United States.* [Emphasis supplied.]

Explanation of provisions: The committee's amendment provides that for purposes of the tax haven foreign base company sales rules of Subpart F, personal property does not include agricultural commodities grown or produced outside the United States if sold for use, consumption or disposition outside the United States. The committee believes that this rule will be easier for the Internal Revenue Service to administer than either the rule contained in present law or the rule contained in the House bill."

As noted above, in accordance with its consideration of the House-passed Tax Reform act of 1975, the Senate Finance Committee initially adopted an agricultural commodities exception based on the third market country approach. This language was subsequently dropped from the Senate-passed Tax Reform Act of 1976.[24]

Although the House-Senate Conference Committee on the Tax Reform Act of 1976 chose not to adopt the agricultural exception to Subpart F under Section 1025 of the House-passed Tax Reform Act of 1975, it is significant that both the House Ways and Means Committee and the Senate Finance Committee had determined that important United States national and international interest would be served by preserving an ongoing opportunity for United States owned firms to participate in international agrucultural trade, the final provisions of the Tax Reform Act of 1976 left unchanged the language of the Tax Reduction Act of 1975 on this matter.[25]

ECONOMIC AND TRANSACTIONAL DISTINCTIONS INVOLVING INTERNATIONAL TRADING OPERATIONS

The decisions of the House Ways and Means Committee and the Senate Finance Committee to create a new Subpart F exception for income derived from sales of agricultural products produced abroad reflected awareness that in certain instances, United States interests are not served by taxing the operations of United States owned foreign corporations on a current basis. More specifically, the Congress recognized inherent economic distinctions between manufacturing and mining activities on the one hand and agricultural marketing and international trading operations on the other. These industries involve fundamentally different international economic and marketing considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufac-

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[23] See Report of the Committee on Finance, United States Senate, accompanying H.R. 10612, Rep. No. 94-936, 94th Cong, 2d Sess., pp. 232-233, June 10, 1976.

[24] See H.R. 10612, 94th Cong., 2d Sess., August 6, 1976.

[25] See Tax Reform Act of 1976, Public Law 94-455, H.R. 10612, 94th Cong. 2d Sess., 90 Stat. 1520, October 4, 1976.

tured within or without the United States. Owing to the nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods as a consequence of the ability to shift manufacturing processes to various countries.

Conversely, trading of commodities in international commerce is not similarly susceptible to this form of shifting and United States export displacement. For example, grains, oilseeds, and other agricultural commodities are produced by individual farmers in particular countries. The nature and quantity of agricultural commodities depends on matters such as climate, available land, etc. Although most production is consumed in the producing country, residual supplies are sold in world trade channels by exporters and intermediate resellers unrelated to the farmer-producers. Consequently, international agricultural trading activities have traditionally involved a structure that includes intermediate resellers (organized in low-tax jurisdictions) which are controlled by both United States owned companies and foreign companies.

As noted above, the Congress has recognized that the effect of taxing on a current basis the income of United States owned international trading companies would be to shift important commercial advantages to foreign based international trading companies.

International commodities trading

United States controlled foreign based trading companies compete in a complex business requiring skilled management and extensive resoures. The basic role of international commodity traders is to anticipate demand for commodities throughout the world and to position themselves in relation to each of their basic elements of commodities—for example, the commodity itself, freight, foreign exchange, and, in some cases, import levies—so that they can compete for sales as demand emerges. Back-to-back purchases and sales are rarely possible. Instead, positions must be taken before the emergence of new demand or new supply is fully reflected in price adjustments. Risk is unavoidable because values of each of the elements of a commodity trade are subject to continuous change. Effective management of risk in this environment is critical to success. Both the volume and value of the commodities involved in international transactions are enormous. Therefore, substantial working capital is required. Trading firms traditionally operate facilities required to handle and transport commodities.

The need for related companies in international trading operations

Although theoretically, United States trading companies could avoid Subpart F problems by dealing only with unrelated companies, as a matter of practical necessity, this is not possible. As noted below, related companies have been required not for tax reasons, but rather for business and marketing purposes. Furthermore, as noted elsewhere, it is essentially impossible to shift earnings and profits among related companies as a consequence of other provisions of United States tax law.

A number of considerations are involved in deciding whether a domestic affiliated company is necessary to be competitive in buying commodities from or selling commodities to a particular country. For example, the limited amount of business available may not justify the costs of organizing a separate company (Greece, Norway, Sweden, Kenya and Tanzania). Limitations imposed by the local government often are decisive (Eastern Europe and in the People's Republic of China). The dominant role of a government marketing agency may limit competitive opportunities for domestic affiliates (South Africa).

On the other hand, in other countries it is often necessary to use a local subsidiary engaged in domestic marketing, exporting and importing grain. To the extent that a significant free market operates within an exporting country, it is seldom possible to compete as an f.o.b. buyer with other international trading firms which can originate grain through offices and elevators controlled by a domestic affiliate. Sellers in these countries sometimes require and usually prefer to deal with a domestic subsidiary whose representatives are available to provide continuing service and whose assets are physically located within the jurisdiction of the host country. The same considerations often apply to selling grain in countries of ultimate destination. Moreover, both in selling and buying countries, market intelligence gained through involvement in domestic market operations improves opportunities for concluding trades. This can be true even in countries in which government marketing boards play an important role (for example, Canada and Australia). Thus, the decision to organize and deal through a domestic affiliate both in buying and selling agricultural commodites turns mainly on business considerations as distinguished from tax considerations.

For example, most grain imported into the European Common Market is handled by consumers on a levy-paid basis. The Corporation paying the levy is required to register within the European Common Market, and therefore if a United States trading company wishes to export efficiently to the European Common Market, it must have local subsidiary corporations in the European Common Market countries.

Although related companies are often used in these transactions, as a practical matter, there is limited need for concern regarding prospects for shifting earnings and profits among a group of related companies for tax purposes. Policing of inter-company pricing among related firms dealing in agricultural commodities is more simple and effective than policing of transactions in manufactured goods. Prices are easily established based on transactions publicly noted by commodity futures exchanges. Furthermore, comparisons are possible between transactions involving identical commodities with related and unrelated firms. Therefore, in this context, the United States Internal Revenue Service can effectively audit these transactions under Section 482 of the Internal Revenue Code (pertaining to arms-length standards for related companies), on a continuous basis, which provides further support for the proposition that the decision to establish domestic marketing subsidiaries in supplying and consuming countries (and transactions among these related companies) are predicated on business and marketing considerations rather than on considerations.

Typical transactions

The following transactions will illustrate the operations of related companies in international agricultural trade; the limited scope of proposed exceptions; and competition at each stage among United States controlled and foreign controlled foreign based firms. In each case, transactions can involve the related company organized in the country or origin to assemble commodities from producers and local resellers; a related company operating in a country of ultimate use to receive the shipment, break it down, and resell it to local users; and, between these different elements, a separate risk taking profit center capable of assessing world market conditions anticipating demand, identifying supplies available from diverse sources, assembling other elements of an international transaction and putting them all together in a saleable package that meets the needs of sellers in originating countries and buyers in countries of ultimate use.

Production and use abroad (third market countries)

ABC Grain Company, Ltd., a Canadian corporation may buy wheat from the Canadian Wheat Board and resell it f.o.b. Canadian port to ABC International, a United States affiliated international trading company. ABC International, in turn, will resell it c.i.f., or c and f, to an Italian buyer for redistribution to flour millers within Italy (Italian buyer may be a related company). In such a transaction, the ABC group of companies would compete at each stage with foreign controlled international commodities trading firms.

PRODUCTION IN UNITED STATES AND USE ABROAD (U.S. EXPORTS)

Sales of United States grains and other agricultural commodities to foreign destinations typically involve a number of different channels, usually beginning in a company organized in the United States. Sales of wheat to India, for example, almost always involve direct sales from a United States company to the Indian Buying Mission, which maintains offices in the United States. A sale of United States corn to Western Europe could involve a United States company as the f.o.b. seller to an affiliated international trading corporation which avails itself of United States tax incentives designed to stimulate United States exports f.o.b. an American port. The affiliated international trading corporation, in turn, could resell c.i.f. to an unrelated third party for resale in Western Europe. A sale of United States wheat to the Soviet Union also might involve a sale by a United States company to an affiliated international trading corporation f.o.b. delivered on board at an American or St. Lawrence port and a resale by the affiliated international trading corporation to the Soviet grain buying agency.

Production abroad and use in United States

Sales of agricultural commodities produced abroad and imported into the United States also involve somewhat different patterns, usually culminating with a purchase by a United States company. For example, a United States controlled affiliated company in the Philippines, purchases coconut oil and coconut meal from local firms and resells to buyers in the United States (including its United States parent) and in Western Europe (possibly to an affiliated company for resale in the country of ultimate consumption).

Effects of current taxation on competition between U.S.-owned foreign sales companies and their foreign-owned competitors

Without an appropriate exception, United States controlled international trading companies would be subject to United States current taxation on undistributed earnings of most sales of agricultural commodities produced and consumed outside the United States. Such transactions would not have been subject to current taxation in the past. Foreign controlled foreign based international trading companies, able to utilize arrangements which do not subject them to current taxation on income derived from these transactions, will possess a decisive competitive advantage.

The effect of differential tax treatment can be illustrated by an example:

A French based company and a United States based company may engage in similar transactions involving international trade of agricultural commodites. Such commodities can originate from any of a number of major exporting nations, such as the United States, Canada, Brazil, Argentina, South Africa, Australia or the European Community, and move to a number of major importing areas, such as Western Europe, the Indian subcontinent, the Middle East, Central America or elsewhere. A French based company and a United States based company may operate through foreign subsidiaries established in Panama in order to participate on a competitive basis in such international agricultural trade. Each of these companies may purchase soybeans grown in Brazil and ship the commodity to a European nation, realizing a profit of $100 on this type of transaction.

If a Panamanian subsidiary of a United States based company is forced to pay accelerated United States income tax (current taxation of $48 by means of eliminating deferral), the United States based company would have substantially less capital available for competitive purposes ($52 as a result of the $48 United States tax on $100 profit). In contrast, a Panamanian subsidiary of a French based company would pay no immediate tax, as neither Panama nor France would impose a current tax on this type of transaction, thus, all $100 of pre-tax profits would be available for future competitive purposes. Furthermore, even where such profits of the Panamanian subsidiary were repatriated to the French based parent, France would not impose any significant tax on such profits, thus providing a further competitive advantage to French owned trading companies.

Thus, under these circumstances, the United States controlled counterparts in the third market countries trade in agricultural commodities:

Limited capacity to absorb tax disadvantages

Unlike United States controlled firms manufacturing products abroad and distributing them in world markets through a foreign based sales company, United States traders in basic agricultural commodities in world markets possess no unique advantages like established brand franchises or product superiority to offset fundamental tax disadvantages. The products they offer—agricultural surpluses of other countries—are the same products offered by foreign based competitors, acquired from the same sources, and distributed to the same markets.

Financing international trade

An essential requirement for successful competition in this trade is access to adequate amounts of capital. Major sources are retained earnings and borrowings. Impact of differential tax treatment on retained earnings is clear. However, the impact of differential tax treatment on the ability to borrow capital to finance trade is less clear, but equally important.

Capital requirements for international trading operations have increased significantly as commodity prices have risen above levels in the 1960s. Moreover, because prices now fluctuate through a broader range than before, the risks to lenders financing international agricultural trade has increased. Thus, risks associated with lending funds to international traders have increased simultaneously with their capital needs.

There is substantial competition for capital in this area, and foreign based firms (operating with the same prudence and skill as United States based firms) would have a substantial competitive edge over United States based firms if United States based firms are penalized by changes in United States tax law which would provide a comparative advantage to their foreign based competitors.

Human resources

As noted above, risk is unavoidable in international trading of agricultural commodities because the values of all elements of a commodity trade are subject to continuous change. Back-to-back transactions involving these elements are rarely possible and therefore success is heavily dependent upon human judgments of

future events. Skilled merchants and traders, capable of managing risk in this environment, are an essential resource in international trading operations. United States owned firms cannot attract and hold skilled merchants and traders also sought by foreign based firms if, because of substantial tax advantages, earnings from operations reflecting the same level of skill and insight are no more than half the earnings of their foreign competitors.

Collateral effects on U.S. exports

An ability to compete effectively on an international basis in global commodities transactions would severly limit the capacity of United States based international trading companies to locate and expand markets for surplus agricultural commodities produced in this country.

The needs of buyers of agricultural commodities in international markets often can be met by supplies from a number of possible origins. Indeed, sellers are often given the option of supplying agricultural commodities produced in different countries. United States based international trading firms typically have substantially greater investments in facilities for originating, handling, transporting, storing and delivering agricultural commodities produced in the United States, and therefore have a greater incentive to encourage the purchase of commodities produced in this country wherever possible. Their inability to compete in all international transactions involving agricultural commodities would deprive the United States of opportunities that would otherwise exist for substituting exportable surpluses of agricultural commodities produced in the United States.

It is important for another reason that United States based firms participate in transactions involving commodities produced abroad even where the possibility of substituting United States commodities does not exist. Market intelligence gained in these transactions increases the effectiveness of U.S. based international trading firms in selling United States produced commodities abroad. Market intelligence enables a trader to anticipate events and to take positions before prices adjust to reflect the influence of new supply and demand. By trading in all international markets, United States based international trading companies are better positioned to sell agricultural products produced in the United States.

CONGRESSIONAL CONCERN ABOUT THE COMPETITIVE POSITION OF THE UNITED STATES IN INTERNATIONAL TRADE NEGOTIATIONS

Trade Act of 1974

In his opening statement of March 4, 1974, commencing the Senate Finance Committee hearings on the Trade Reform Act of 1973, H.R. 10710 (later to be voted into law as the Trade Act of 1974), Chairman Russell B. Long stated:[36] "*I was very much in favor of the Trade Expansion Act of 1962. I still desire an 'open nondiscriminatory, and fair world economic system' but I am tired of the United States being the 'least favored nation' in a world which is full of discrimination. We can no longer expose our markets, while the rest of the world hides behind variable levies, export subsidies, import equalization fees, border taxes, cartels, government procurement practices, dumping, import quotas, and a host of other practices which effectively bar our products.*" [Emphasis supplied.]

GATT reform

In the context of reform of the General Agreement on Tariffs and Trade ("GATT"), the Congress has specifically instructed United States trade negotiators to seek revision of those GATT articles which discriminate against the United States, and it is clear from the statutory language that the Congress was particularly concerned about this matter with respect to the DISC:[37]

"The President shall, as soon as practicable, take such action as may be necessary to bring trade agreements heretofore entered into, and the application thereof, into conformity with principles promoting the development of an open, nondiscriminatory, and fair world economic system. The action and principles referred to in the preceding sentence include, but are not limited to, the following—

"The revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs . . ."

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[36] See Hearings before the Senate Finance Committee concerning The Trade Reform Act of 1973, H.R. 10710; Part 1, p. 2, 93rd Cong., 2d Sess., March 4 and 5, 1974.

[37] See § 121 of the Trade Act of 1974 Public Law 93-618, H.R. 10710, 93rd Cong., 2d Sess., 88 Stat. 1978, January 3, 1975.

Congressional oversight involving international trade negotiations

The Senate Finance Committee has stated that the Congress will be actively involved in securing full reciprocity and equal competitive opportunities for United States interests: [28] "The Trade Reform Act, as reported by the Committee, is intended to be more than a delegation of authority for negotiated reduction in the rates of duty. While a significant authority to reduce tariffs would be provided to insure the flexibility the trade negotiations will require, our foreign trading partners and our negotiators are on notice that the authority must be exercised to obtain full reciprocity and equal competitive opportunities for U.S. commerce."

House Ways and Means Committee task force on U.S. taxation on foreign source income

During the course of consideration of the Tax Reform Act of 1975, the House Ways and Means Committee established a special task force to study the United States taxation of foreign source income (sometimes hereinafter referred to as the "Foreign Source Income Task Force"). This task force was instructed to report its findings and recommendations to the full Committee.[29]

On March 8, 1977, the Foreign Source Income Task Force issued its report (sometime hereinafter referred to as the "Foreign Source Income Task Force Report").[30]

Based on its deliberations, the Foreign Source Income Task Force recommended no changes with respect to the tax treatment of deferred earnings of foreign corporations controlled by United States shareholders.[31]

The final statement of the Foreign Source Income Task Force on this matter not only reconfirms strong support for international and multilateral approaches to certain international tax policy issues (as distinguished from unilateral action under the Internal Revenue Code), but the language chosen for this purpose is even broader is scope than the language contained in earlier draft reports: [32] "*In its consideration of the several questions referred to it, the task force found that fundamental change by the United States in the taxation of foreign source income many areas requires the agreement and cooperation of foreign governments. Certain changes which might otherwise have been appropriate were found not to be acceptable if unilaterally adopted by the United States because they would subject U.S. businesses operating abroad to tax while their foreign competitors would not be similarly taxed, thus placing the U.S. businesses at a competitive disadvantage. Other were found to be unacceptable because they would subject foreign businesses to U.S. tax under circumstances involving a substantial possibility of retaliatory taxes by foreign governments against U.S. businesses operating abroad. Therefore, in addition to its specific recommendations directed toward the particular issues considered by the task force, the task force strongly recommends that steps be taken to initiate multilateral discussion between the United States and our major trading partners to consider a broad range of tax and investment questions, in particular those areas where unilateral action by any single nation is not feasible.*" [*Emphasis supplied.*]

GATT PANEL DECISIONS ON CERTAIN TAX PRACTICES OF THE UNITED STATES, FRANCE, BELGIUM, AND THE NETHERLANDS

GATT DISC panel decisions

In accordance with procedures under the provisions of the General Agreement on Tariffs and Trade ("GATT"), a panel was established in July 1973 to examine a complaint submitted by the European Communities ("EC"), pursuant to paragraph 2 of Article XXIII of the GATT, relating to United States tax legislation on the Domestic International Sales Corporation ("DISC"), and to make such findings as would assist the Contracting Parties of GATT to make recommendations or rulings provided for in paragraph 2 of Article XXIII of GATT (his panel is sometimes hereinafter referred to as the "GATT DISC Panel").

The EC requested the GATT DISC Panel to find that the DISC system was incompatible with the relevant clauses of GATT regarding export subsidies.

In the course of its proceedings, the GATT DISC Panel held consultations with the EC and the United States, and background arguments and information were submitted by both parties.

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[28] See Report of the Senate Finance Committee accompanying H.R. 10710, p. 18, S. Rept. No. 93-1298, 93rd Cong., 2d Sess., November 26, 1974.

[29] See Press Release No. 12, House Ways and Means Committee, January 5, 1976.

[30] See House and Ways and Means Committee report entitled "Recommendations of the Task Force on Foreign Source Income", 95th Cong., 1st Sess., March 8, 1977.

[31] *Id.* at p. 59.

[32] *Id.* at p. 2.

Based on its findings, in November 1976, the GATT DISC Panel concluded that the DISC legislation, in some cases, had effect which were not in accordance with United States' obligations under Article XVI(4) of GATT and that as it had found the DISC legislation to constitute an export subsidy which had let to an increase in exports it was also covered by the notification obligation contained in Article XVI(1) of GATT and that accordingly there was prima facie case of nullificaiton or impairment of benefits under GATT.

GATT European tax practices panel decisions

Partially in response to the aforementioned EC complaint, the United States initiated counter claims and proceedings against certain tax practices of France, Belgium and the Netherlands alleging that such tax practices constituted export subsidies in violation of GATT. In accordance with GATT procedures, separate GATT panels were established in July 1973 to examine the United States complaints with respect to each of the subject countries, pursuant to paragraph 2 of Article XXIII of the GATT, and to make recommendations or rulings provided for in paragraph 2 of Article XXIII of the GATT (these panels are sometimes hereinafter collectively referred to as the "GATT European Tax Practices Panels").

The United States requested the GATT European Tax Practices panels to find that certain tax practices of France, Belgium and the Netherlands violated Article XVI(4) of GATT and that these were nullifying or impairing benefits accruing to the United States under GATT.

The United States also suggested that the four complaints involving the DISC and certain tax practices of France, Belgium and the Netherlands should be considered together because they raised the same principles concerning application of GATT.

In the course of its proceedings the GATT European Tax Practices Panels held consultation with the United States, France, Belgium and the Netherlands, and background arguments and relevant information were submitted by each of these parties.

Based on their findings, in November 1976, the GATT European Tax Practices Panels concluded that the tax practices of France, Belgium and the Netherlands, in some cases, had effects which were not in accordance with the respective obligations of these countries under Article XVI(4) of GATT and that as these practices had been found to constitute export subsidies which had led to obligations contained in Article XVI(1) of GATT and that accordingly there were prima facie cases of nullification or impairment of benefits under GATT with respect to the subject practices of each of these countries.

Representative GATT panel findings and determinations on income tax practices of France

The GATT panel on French tax practices related the following factual aspects regarding the tax practices in question.[33]

"The French income tax system for corporations is based on the territoriality principle which, in general, taxes income earned in France but not income arising outside France. It is a principle deriving from the history of the French system dating back to the beginning of the century. French companies are liable to corporation tax solely in respect of profits made by enterprises operating in France and of profits taxable by France under an international double taxation agreement (Article 209:1 of Code Generale des Impots).

"Under the territoriality rule as applied by France profits generated by undertakings operated abroad are exempt from French taxation. On the other hand, a French company is not entitled to any foreign tax credit and cannot deduct losses suffered abroad, apart from exceptions specified below.

"Ninety-five per cent of dividends from the French or foreign subsidiaries of a French company is excluded from the profits of the parent corporation. Participation by the parent in the subsidiary must exceed 10 per cent (Article 145 and 216 of CGI)."

On the effects of the territoriality principle as applied by France for taxation of foreign profits, the panel noted:[34]

"The representatives of the United States pointed out that France followed the territoriality principle of taxation, and that as a result, did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms. Taxes on such income were the most part permanently forgiven rather than merely deferred. He stated that the exclusion apparently extended to foreign source income from activities carried out by a French selling corporation through its own agents or employees abroad even without a foreign permanent establishment, as

[33] See Report of GATT Panel on Income Taxes Maintained by France, p. 2, November 2, 1976.
[34] *Id.* at p. 4.

income from transactions which were separate from the corporation's French operations and which constituted complete commercial cycles outside France were excludable. The representative of the United States argued that these provisions, and relaxed intercompany pricing rules and other practices in relation to export transactions, created a distortion in conditions of international competition in that they afforded remission or exemption of direct taxes in respect of exports in violation of France's commitment as a contracting party under Article XVI:4. The permanent exemption could be freely used by the domestic manufacturing firm. The relative tax burden on the sales of products for export as against domestic sales was lower as a result of the remission.

"The representatives of the United States argued that, by organizing a foreign branch or subsidiary in a low-tax country, a French manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign brranch or foreign sales subsidiary, that the amount of export sales income allocated to foreign sources was generally substantial, that under the French system the right to tax foreign income was given up. He concluded that at a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI:4."

The panel stated the following concerning the effects of the territoriality principle as applied by France for taxation of foreign dividends: [35]

"The representatives of the United States stated that under the territorial principle, profits of a foreign subsidiary were not consolidated with the profits of its French parent, and so not taxed in France. He went on to make the point that even if the subsidiaries' profits were repatriated in the form of a dividend, 95 per cent of it was deducted from the taxable income of the company, whether or not the foreign subsidiary was subject to taxes in its country of residence, and whether or not the rate of tax applied by that country was less than the French rate. In fact, the dividend was not expected to be taxed at all, as the remaining 5 per cent was considered to be deducted as ordinary expenses against the taxes of the recipient corporation. He argued that this amounted to a permanent exemption from taxation."

In its conclusion and recommendations, the panel determined the following: [36]

"The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.

"The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

"The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved."

"The Panel therefore concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI:4."

"The Panel considered that the fact that these arrangements might have existed before the General Agreement was not a justification for them and noted that France had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p. 32).

"The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1.

"In the light of the above, and bearing in mind the precedent set by the Uruguayan cases (BISD, 11 Suppl. p. 100), the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement."

The relevant GATT panels charged with responsibility for reviewing the income tax practices of Belgium and the Netherlands made findings and determinations similar to those for France in concluding that the tax practices of Belgium and the Netherlands were also in violation of GATT obligations.

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[35] *Id.* at p. 7.
[36] *Id.* at pp. 11-13.

Congressional involvement in GATT panel proceedings

During the course of GATT consideration of DISC and certain tax practices of France, Belgium and the Netherlands, Members of the House Ways and Means Committee and the Senate Finance Committee participated in the GATT sessions in Geneva, Switzerland. Based on these international proceedings, and other arguments and submissions, Members of the House Ways and Means Committee and the Senate Finance Committee have recently indicated that the United States should take a hardline poisition on these issues in international trade negotiations (as distinguished from United States unilateral action on DISC), and that such an approach comports with United States international tax and trade policy objectives and United States international negotiating opportunities.

Although representatives of the European Communities and the United States raised the GATT Panel Decisions at the GATT Council meeting in Geneva, Switzerland on March 2, 1977, it is understood that this matter has, on several occasions, been postponed for further consideration. In this regard, it is important for the representatives of the United States to be well prepared on substantive and procedural issues and negotiating techniques in order to maximize opportunities for obtaining beneficial results for the United States in these proceedings. Such efforts should emphasize consultations and technical analysis involving Members and staff of the House Ways and Means Committee and the Senate Finance Committee, staff of the Joint Committee on Taxation, and officials of STR and Treasury in an effort to obtain a United States domestic consensus of these issues before undertaking specific initiatives in an international context.

In the past, representatives of the United States federal government have experienced ongoing difficulties in attempting to secure open and nondiscriminatory treatment for United States exports through elimination or reduction of trade distorting practices of other nations.

Nevertheless, new opportunities are now available concerning the relationship of United States domestic tax legislation and international trade proceedings and negotiations, particularly in the context of the GATT Panel Decisions. Based on the continued unwillingness of the subject European governments to adopt or proceed with the findings of the GATT Panels, it is particularly important that the United States Congress proceed with necessary changes in United States federal income tax law to offset, in part, the tax incentives of other countries which are directed to providing a competitive advantage for the exports and international trading activities of such countries.

In this regard, it should be recognized that the European countries which were found in violations of GATT obligations by the subject GATT Panels have refused to make any concessions whatever on this matter and have resisted any form of international solution concerning these decisions. If the United States is to proceed with its efforts to obtain an internationaal resolution of this problem by means of international trade negotiations, it is necessary and proper, and in accordance with United States international tax and trade policy objectives, that the United States Congress adopt requisite changes in United States tax law to obtain comparability with the tax practices of other countries and thus strengthen the United States bargaining position by providing needed leverage and negotiating tools for dealing with the trade distorting and discriminatory tax practices of other nations.

U.S. CONGRESSIONAL CONCERN ABOUT SUBSTANTIAL U.S. TRADE DEFICIT WITH JAPAN

House Ways and Means Committee task force on United States-Japan trade

The report of the House Ways and Means Committee Task Force on United States-Japan Trade related that despite Japanese trade liberalization in recent years, a wide range of trade and structural barriers remain in Japan which restrict imports, interfere with the currency alignment process, and perpetuate the United States-Japan trade imbalance.

Members of the Task Force related that they had attempted to express this urgent message to Japanese government and business representatives, although such Members were not sure that they were heard or understood. In some cases, it was felt that Japanese officials believed that the situation was serious and were trying to correct the problems, while in other cases, the Members encountered absolutely no understanding of how destructive Japan's excessive trade surpluses were to the world economy, and how much concern these trade imbalances had created in other nations.

The Members related the following in the Task Force Report: [37]

[37] See House Ways and Means Committee, Subcommittee on Trade Task Force Report on United States-Japan Trade, 95th Cong., 2d Sess., pp. V, 6, 44 and 45, January 2, 1979.

"We have offered some observations and proposals on these longer range issues. Some of these proposals extend outside of the jurisdiction of the Subcommittee on Trade and involve issues such as tax policy, antitrust, export promotion, and government, organization.

"We hope that interested parties will comment on the proposals in this report and assist the Subcommittee in exploring ways to deal with the problems we have identified. The need is urgent for a long-range national policy to deal with these international trade issues." [Emphasis supplied.]

"It is probable that in addition to curbing domestic inflation, more important, long-range encouragement of exports rests with the U.S. Government in terms of

(a) *Tax incentives, consistent with U.S. multilateral obligations, which will encourage firms to undertake the heavy costs of entering new markets;*

(b) Relaxation or exemption of anti-trust laws in certain overseas situations, while continuing competition domestically;

(c) Increased emphasis in the United States on industrial R. & D. innovation;

(d) Access to capital for small U.S. firms selling or operating aborad;

(e) Willingness to match the full range of export credit services offered by foreign export organizations (pending agreement with trading partners to limit such export competition);

(f) Better organization of Federal government to encourage U.S. commercial interests abroad and to give more emphasis and visability to the importance of exports." [Emphasis supplied.]

"It is probable, however, that more important, long-range encouragement of exports rests with the U.S. Government in terms of such issues as:

(a) *Tax incentives;*

(b) Clarification of U.S. anti-trust laws to export sales abroad;

(c) Renewed R. & D. emphasis along with easier conversion of R. & D. into industrial innovation;

(d) Access to capital for small U.S. firms selling/operating abroad;

(e) Improved Eximbank services;

(f) Increased coordination among, and status for U.S. agencies promoting exports;

(g) *Development of the trading company concept for U.S. companies.*

While we recognize that many economists question the need for export promotion programs, particularly in a world of freely floating exchange rates, we are concerned that this view is somewhat unrealistic in light of the many export promotion programs provided by our major competitors. For example the Library of Congress has recently prepared a report entitled "Export Stimulation Programs in the Major Industrial Countries: The United States and Eight Major Competitors," which contains several table comparisons *showing the need for the United States to (1) either obtain agreement among its trading partners to limit export promotion programs or (2) to improve the quality of its own programs.*

Therefore, we believe that the general ideas listed above should be discussed at greater length.

(1) *The Task Force is reviewing a number of proposals in the general area of taxation to encourage U.S. competition in world markets. It is important, of course, that any such changes not violate existing GATT rules or provide the kind of export subsidies which will be covered by the Subsidies Code in the MTN Agreement."* [Emphasis supplied.]

Advantages provided by the Japanese Government to Japanese trading companies

Although major Japanese trading companies are publicly owned, large Japanese banks and insurance companies often own substantial blocks of the stock of such trading companies. Japanese trading companies typically operate through a Japanese parent corporation and various local subsidiary corporations in countries where the trading company does business.

Japanese trading companies rely extensively on debt financing as the primary source of funds for international business operations, and debt to equity ratios of such companies are exceedingly high by United States standards. Interest is deductable, and net profits after interest tend to be relatively modest owing to substantial debt carried by the trading companies. A key factor supporting the competitive position of Japanese trading companies in world trading markets is the extent to which debt is considered to be premanently invested in the business. In this regard, it is particularly important to understand the manner in which debt and equity are generally viewed in Japan. Japanese banks which provide permanent short-term debt, although not having strict voting power as a shareholder, nevertheless because of the unusually high debt to equity ratios (seldom less than 9 to 1), have a very real direct influence on the thrust and direction of Japanese trading companies. It is implicit in this almost partnership-like realtionship that the banks will not call

their loans should the trading company run into temporary unfortunate trading experiences. This type of relationship, although not found, nor probably permitted, in the United States, nevertheless, accounts for the relatively substantial exposures that a Japanese trading company may undertake, based on the very high debt to equity ratios. Apparently this type of financing is an intergal part of the toal Japanese economic system which encourages and permits Japanese trading companies engage in very large volume and very low margin business which in turn promotes Japanese industrial growth margins.

The Japanese system has other build-in advantages, such as limited, if any, concern about anti-trust considerations, intercompany investments, and seemingly inexhaustible availability of credit. Of course, none of these advantages are readily available under the United States system.

The following excerpt from a business periodical recognizes the advantages which accrue to Japanese trading companies and supports the points noted above.[38]

"There are 6,000 of so trading companies in all, but most of the business is done by the Big Six (which also includes C. Itoh & Co., Marubeni Corp., Sumitomo Shoji and Missho-Iwai Co.).

The trading companies do things which would send the Justice Department rushing into court if American companies did them. Often their business comes to them from banks that are large investors not only in the trading companies but also in the companies whose goods the trading firms deal. Thus, for example, Dai-Ichi Kangyo Bank owns nearly 10 percent of C. Itoh & Co.; Fuji Bank owns over 7 percent of Marubeni Corp. Both banks are large investors in several textile companies with which the two trading companies do business. *There is ample room for restraining trade and fixing prices by Japanese managers who tend to be more interested in orderly markets than abstract principles of perfect competition.*

Their balance sheets would shock most American security analysts. They go after huge volumes with razor-thin margins—usually 3 percent, often less—on the theory that profits will take care of themselves. And they do it all on a shoestring, piling ponderous debt on minimal equity. With a debt-to-equity ratio of 9.4 (based on total debt), Mitsubishi is the group's least leveraged outfit." [Emphasis supplied.]

Based in part on the points and considerations noted above, it is suggested that the United States tax system should be modified to permit, and indeed to encourage, United States owned trading companies to compete with Japanese trading companies by adopting a tax policy more in line with other countries of the Western World.

SUBSIDIES AND COUNTERVAILING DUTY CODE

During the course of the MTN and in accordance with the provisions of the Trade Act of 1974, United States trade negotiators have attempted to obtain greater discipline over the use of foreign subsidies that confer unfair competitive advantages upon the products of the subsidizing country. The MTN agreement on subsidies and countervailing duties affords an opportunity to achieve certain of these United States objectives by permitting the United States to limit foreign subsidy practices without sacrificing the ability to make effective use of United States countervailing duty law.

The subsidies and Countervailing Duty Code ("Subsidies Code") has now been signed by the delegations of the major industrialized countries.[39] This code represents an interpretation and elaboration of GATT Articles VI, XVI and XXIII, relating to subsidies and countervailing measures. Key elements of the subsidies code include the following:

"(1) A flat prohibition on export subsidies on nonprimary products as well as primary mineral products;

"(2) Special rules for developing countries under which signatories would agree to reduce and eliminate their export subsidies on nonprimary products, as well as primary mineral products;

"(3) Illustrative provisions on subsidies other than export subsidies which recognize the legitimacy of such programs but also recognize that such subsidies may cause injury or serious prejudice, or nullify or impair GATT benefits accruing to their signatories, particularly when such suosidies are granted on noncommercial terms, and a commitment to seek to avoid such trade effects and provision for remedies where they are causes;

"(4) Improved rules on agricultural export subsidies, with particular reference to interests in third-country markets;

[38] See a Business In Billions, A Profit in thousands, Forbes, P. 90, July 10, 1978.

[39] See Subsidies/Countervailing Measures Text of the Multilateral Trade Negotiations Group on Nontariff Measures, subgroup on Subsidies and Countervailing Duties, April 5, 1979.

"(5) A two track set of remedies designed to provide expeditious countermeasures when subsidized competition causes problems in the United States market or in United States export markets;

"(6) A dispute settlement mechanism designed to provide quick resolution of subsidy and countervailing disputes and to provide a growing case law in the GATT on such problems."

Under the provisions of the Subsidies Code, the signatories recognized that subsidies are used by governments to promote important objectives of social and economic policy and also recognized that subsidies may cause adverse effects to the interests of other signatories.

The signatories agreed not to use export subsidies in a manner inconsistent with the provisions of the Subsidies Code.

Article 9 of the Subsidies Code, pertaining to export subsidies, provides:[40]

"(1) Signatories shall not grant export subsidies on products other than certain primary products.

"(2) The practices listed in points (a) to (l) in Annex are illustrative of export subsidies."

Article 18, Section 6 of the Subsidies code, pertaining to dispute settlement and review, provides:[41]

"6. The Committee shall review annually the implementation and operation of this Agreement taking into account the objectives thereof. The Committee shall annually inform the Contracting Parties to the GATT of developments during the period covered by such review.[1]

[1] *At the first such review, the Committee shall, in addition to its general review of the operation or Agreement, offer all interested signatories an opportunity to raise questions and discuss issues concerning specific subsidy practices and the impact on trade, if any, of certain direct tax practices."* [Emphasis supplied.]

Note 2 of the annex to the Subsidies Code provides:[42]

"The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. *The signatories further recognize that nothing in this text prejudges the disposition by the Contracting Parties of the specific issues raised in GATT document L/4422."* [Emphasis supplied.]

The language cited above expressly provides that the GATT Panel Decision involving DISC is not covered by the Subsidies, Code, and based on an earlier draft of the text it appears that the GATT Panel Decisions involving the tax practices of France, Belgium and the *Netherlands* are also not covered by the Subsidies Code.

Accordingly, despite the major efforts of United States trade negotiators, it is clear that the Subsidies Code does not resolve the basic issues of direct tax incentives for exports and that it sidesteps the findings under the GATT Panel Decisions, although the Subsidies Code Committee is obligated to provide the United States an opportunity to raise again the matter of the impact of direct tax practices on trade.

The considerations related above further support the proposition that the United States Congress should now proceed with changes in the United States tax law, as recommended in this memorandum, to protect important United States interests and to provide needed negotiating leverage to United States trade negotiations in the forthcoming international deliberations on the subject issues.

Conclusion and Recommendations

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide, territorial, and certain forms of exemptions and credits), not one of the major free market trading nations of the world, other then the United States, taxes currently the undistributed earnings and profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes undistributed earnings and profits of United States owned international trading firms on a current basis, this places United States based companies engaged in international trading operations at a substantial competitive disadvantage and constitutes a departure from the general scheme of international taxation practiced by other nations.

During the course of consideration and evaluation of the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Reduction Act of 1978, the deliberations and recommendations of the House Ways and Means Committee Task Force on Taxation of Foreign Source Income, the House Ways and Means Committee Task Force on United States-Japan Trade, the GATT Panel Decisions, the Subsidies Code

[40] *Id.* at p. 20.
[41] *Id.* at p. 35.
[42] *Id.* at p. 40.

and most recently the deliberations and recommendations of the House Ways and Means Committee and the Senate Finance Committee concerning the Tokyo Round of MTN international agreements and related domestic legislation, the United States Congress had indicated an increasing awareness that, in certain instances, United States interests are not served by taxing currently the undistributed earnings and profits of United States owned foreign corporations.

More specifically, the Congress has recognized inherent economic distinctions between manufacturing and production operations on the one hand, and international marketing and trading activities on the other. These industries involve fundamentally different transactional considerations. A manufacturing company may utilize a trading affiliate in a low-tax jurisdiction to handle exports of its products manufactured within or without the United States. Owing to nature of manufacturing processes, such arrangements could potentially displace United States exports of domestically manufactured goods (and United States jobs) as a consequence of the ability to shift manufacturing processes to foreign countries. Conversely, trading operations in international commerce are not similarly susceptible to this form of shifing which could result in displacement of United States exports and jobs.

Unless the United States provides an exception from current taxation of earnings and profits of United States owned firms derived from international trading activities (similar to the practice of other countries which do not tax such income on a current basis), the competitive position of United States trading firms will be undermined and ultimately this business will be transferred to foreign owned firms beyond United States tax jurisdiction and control.

Furthermore, the continuing substantial United States trade deficit suggests that it is extremely important that United States owned international trading firms be provided an opportunity to compete on a substantially equivalent tax footing with foreign owned firms in world trade. Unless United States firms are accorded similar tax treatment to their foreign owned competitors, such United States firms will be displaced in world trading markets. In this regard, United States firms possess no special advantages which would enalbe them to absorb significant additional tax burdens. United State firms buy and sell the same products and commodities as their foreign owned competitors.

During the consideration of the legislation which was enacted into law as the Trade Act of 1974, various representatives of the United States Congress expressed concern about the United States position in world trade while specifically noting the need for an open nondiscriminatory and fair world trading system. It was recognized that the United States could no longer expose its markets while other nations utilize all manner of government-instituted practices to effectively bar United States products and distort international trade.

The members of the House Ways and Means Committee, the Senate Finance Committee and the Congress as a whole have stressed the need for utilizing both international and domestic approaches with respect to United States international tax and trade policy issues so as to preserve important United States interests. Unfortunately, based on the continuing refusal of various European countries to adopt and proceed with the GATT Panel Decisions and the inability of United States trade negotiations to obtain requisite limitations and international rules on the use of direct tax export incentives under the provisions of the Subsidies Code (despite major efforts by our trade negotiations in both of these areas), the United States is now faced with a pressing need to make changes in United States tax law to obtain comparability with the tax practices of other countries which compete with the United States for world trading markets.

Based on the points, authorities, developments and considerations set forth above, it is urged that the Members of the House Ways and Means Committee, the Senate Finance Committee, and the Congress as a whole proceed expeditiously with necessary changes in United States federal income tax law to assure that United States owned firms engaged in international trading of agricultural commodities will be placed on a substantially equivalent tax footing with their foreign owned competitors.

Respectfully submitted.

PAUL H. DELANEY, Jr.

ATTACHMENT A

GENERAL CONSIDERATIONS REGARDING U.S. TAXATION OF FOREIGN SOURCE INCOME

Tax jurisdiction and taxation of foreign source income

A particular nation may tax the worldwide income of its nationals, restrict the scope of its tax jurisdiction to a territorial basis (tax only domestic source income), or provide for other means of limiting the taxation of foreign source income.

In response to a United States Congressional inquiry in March 1973, a study was prepared under the auspices of the Council on International Economic Policy ("CIEP") (regarding tax treatment by other nations of their own multinational firms (taxation of foreign source income).[1]

This study summarized the basic rules of the following countries with respect to taxation of foreign source income: Belgium, Brazil, Canada, Denmark, France, Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Norway, Switzerland, and the United Kingdom.

The analysis included:

(1) Taxation of income of foreign branches of domestic corporations;

(2) Taxation of foreign subsidiaries of domestic corporations;

(3) Taxation of interest, dividends and patent royalties received from abroad; and

(4) Treatment of foreign taxes paid by domestic corporations and their subsidiaries (in certain instances, inter-company pricing practices were considered).

Although it is difficult to generalize concerning the effect of foreign tax systems with respect to taxation of foreign source income, it should be noted that despite varied approaches to taxation (worldwide, territorial, and varied forms of exemptions and credits), not one of the nations considered in the CIEP study taxed currently the undistributed profits of a foreign subsidiary controlled by local residents. Accordingly, to the extent that the United States taxes undistributed profits of United States controlled foreign corporations on a current basis, this places United States based companies engaged in international operations at a competitive disadvantage and constitutes a departure from the general scheme of international taxation practicied by other nations.

U.S. constitutional considerations

In accordance with the principal taxation provisions of the Constitution of the United States (sometimes hereinafter referred to as the "Constitution"), the United States Congress (sometimes hereinafter referred to as the "Congress"), possesses the power to lay and collect, taxes, duties, imposts, and excises to pay the debts and provide for common defense and general welfare of the United States, provided such duties, imposts and excises shall be uniform through the United States.[2]

Under the Constitution, as initially ratified, the Congress could only impose direct taxes in proportion to the census (apportionment on the basis of population).[3] However, pursuant to Constitutional Amendment, the Congress is now empowered to lay and collect taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.[4] Although the Congress has exercised its Constitutional tax authority in enacting the provisions of the United States Internal Revenue Code,[5] administration of United States federal income tax laws has generally been delegated to the United States Treasury Department and the Internal Revenue Service.[6]

U.S. tax jurisdiction

United States federal tax jurisdiction is based on two general principles:[7]

(1) Nationality, under which the United States taxes worldwide income of "United States persons";[8] and

[1] See information submitted for the record by the Council on International Economic Policy to the Subcommittee on International Trade, Senate Finance Committee, Hearings on Multinational Enterprises, February 26 through March 6, 1973.

[2] See U.S. Const. Art. I, Sec. 8.

[3] See U.S. Const. Art. I, Sec. 9.

[4] See U.S. Const. Amend. XVI.

[5] See Internal Revenue Code of 1954, as amended, Title 26 U.S.C. § 1 *et seq.* (sometimes hereinafter referred to as the "I.R.C.").

[6] The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, is charged with the responsibility for prescribing and publishing rules and regulations for the enforcement of United States income taxes. See I.R.C. § 62.

[7] I.R.C. §§ 1 and 11(a) set forth very broad jurisdictional rules, imposing tax on the taxable income of "every individual" and "every corporation", respectively.

[8] The term "United States person" and other relevant terms pertaining to United States tax jurisdiction are defined and discussed subsequently in this memorandum.

(2) Source of income, under which the United States taxes "United States source income" of United States persons and "foreign persons", including "nonresident aliens" and "foreign corporations" (in limited circumstances, the United States taxes "foreign source income" of foreign persons "effectively connected with a United States trade or business").

Accordingly, under relevant provisions of the Internal Revenue Code, nonresident aliens and foreign corporations are subject to United States federal income tax on:[9]

(1) Income derived from United States sources; and

(2) Income effectively connected with a United States trade or business.

The term "United States person" includes United States domestic corporation.[10]

U.S. taxation of U.S. corporations and foreign corporations

As noted above, United States tax jurisdiction is based on both nationality and source of income. The United States taxes United States persons (citizens, residents, corporations, partnerships, trusts, etc.) on income from all sources.

The modern United States corporate income tax dates from 1909. At that time, domestic corporations were taxed on income from all sources and foreign corporations on income from business transacted and capital invested within the United States. This jurisdictional pattern remained substantially unchanged until 1962.

The impact of tax on the foreign source income of United States persons was softened somewhat in 1918 with the adoption of a foreign tax credit. Previously, foreign taxes had merely been deductable, like state and local taxes. The credit can apply to both the earnings and profits of foreign subsidiary corporations and foreign branches. Only payments treated as income taxes, or "in lieu of income taxes", qualify for the credit.[11]

The income of foreign corporations, if derived from business conducted outside the United States, is generally not subject to current United States income taxation.

In broad terms, a corporation is treated as a United States domestic corporation if it is incorporated in any of the states of the United States or the District of Columbia and is treated as a foreign corporation if it derives its charter from a foreign government.

Foreign source income earned by a foreign corporation controlled by United States persons is generally exempt from United States taxation until distributed to shareholders who are United States persons.[12] The effect of these provisions of the Internal Revenue Code is that a United States person (United States shareholder) is allowed to defer paying United States income tax on undistributed earnings and profits of a controlled foreign subsidiary corporation until such earnings and profits are repatriated to the United States (this development is often referred to as "deferral" of tax with respect to foreign investment).

A corporation receiving a dividend from a controlled United States domestic corporation is generally entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax.[13] Dividends from a foreign corporation are not entitled to this exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals.[14] Therefore, United States shareholders of foreign corporations are generally taxed fully on dividends received from foreign corporations.

A United States corporation which in any taxable year owns at least 10 percent of the voting stock of a foreign corporation from which it received dividends is entitled to a foreign tax credit for income taxes paid by that foreign corporation.[15]

Current taxation of undistributed earnings and profits of foreign corporations

Although United States shareholders (United States persons) of foreign corporations are generally not subject to United States tax on the income of such foreign corporations unless, and until, such income is repatriated to the United States in the form of dividends (or remittances in the nature of a dividend), United States shareholders of two categories of foreign corporations are effectively subject to current United States taxation on certain types of undistributed income:

(1) "Foreign personal holding companies"; and

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[9] See I.R.C. §§ 871, 872, 881 and 882 which limit United States tax jurisdiction with respect to taxation of nonresident aliens and foreign corporations to income from sources within the United States and income effectively connected with the conduct of a United States trade or business.

[10] I.R.C. § 7701(a)(30) defines "United States person" to include citizens, residents, domestic partnerships, domestic corporations and domestic estates and trusts.

[11] See I.R.C. §§ 901-906.

[12] See I.R.C. §§ 1, 11, 861-864, 881-883, and 1201.

[13] See I.R.C. § 243.

[14] See I.R.C. § 116.

[15] See I.R.C. § 902.

(2) "Controlled foreign corporations."

U.S. TAXATION OF FOREIGN PERSONAL HOLDING COMPANIES

A foreign corporation is treated as a foreign personal holding company:

(1) If at least 60 percent of the corporation's gross income for the taxable year is foreign personal holding company income (passive income such as dividends, interest, rents and royalties); and

(2) If at any time during the taxable year, more than 50 percent in value of the corporation's outstanding stock is held directly or indirectly by not more than five individuals who are citizens or residents of the United States.[16]

The rationale for the foreign personal holding company provisions is to prevent a small group of United States taxpayers from incorporating their investments overseas in order to escape taxation of investment income at the individual level. The shareholders of a foreign personal holding company are subject to current United States taxation on their pro-rata share of the corporation's personal holding company income.

U.S. TAXATION OF CONTROLLED FOREIGN CORPORATIONS UNDER SUBPART F

In accordance with the provisions of the Revenue Act of 1962,[17] the United States Congress added Subpart F to the Internal Revenue Code in an effort to deal with the problem of tax haven operations.[18] Under this approach, United States shareholders of controlled foreign corporations ("CFCs") are subject to current United States income taxation on certain forms of undistributed tainted income (tax haven or Subpart F income):

(1) Subpart F income, including foreign base company income and income derived from insurance of United States risks;

(2) Previously untaxed Subpart F income withdrawn from investment in less developed countries; and

(3) Any increase in investment in United States property to the extent it would be taxable as a dividend if distributed to United States shareholders.

It should be understood that Subpart F taxes United States shareholders not on their own income, but on the income of CFCs in which they own an interest. This development relates to the consideration that there may be no jurisdictional basis for taxing a foreign corporation unless it earns income from sources within the country asserting jurisdiction to tax (or has income effectively connected with business operations in such country). Therefore, Subpart F jurisdiction is predicated on United States citizenship or residence, rather than source of income.

Controlled foreign corporations

A CFC is defined as a foreign corporation whose total combined voting power of all classes of stock entitled to vote is more than 50 percent owned, on any day during the taxable year, by United States shareholders.[19]

A "United States shareholder" is defined as a United States person owning, actually or constructively, 10 percent or more of the total combined voting power of a CFC.[20]

Foreign based company income

Foreign base company income (as noted before, foreign base company income is included in the definition of Subpart F income) is computed on the basis of three components:[21]

(1) Foreign personal holding company income;

(2) Foreign base company sales income; and

(3) Foreign base company services income.

For operational purposes, a primary issue often pertains to tax treatment of foreign base company sales income. Essentially, a CFC engaged in buying and selling personal property to, from, or on behalf of, a related person is treated as generating foreign base company sales income, unless the property has been manufactured, produced, grown, or extracted in the CFC's country of incorporation or is intended to be used, consumed, or disposed of in that country, or both.[22] These rules

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[16] See I.R.C. §§ 551-558.

[17] See Revenue Act of 1962, P.L. 87-834, H.R. 10650, 87th Cong., 2d Sess., 76 Stat. 960, October 16, 1962.

[18] See I.R.C. § 951(a)(1).

[19] See I.R.C. § 957.

[20] See I.R.C. § 951(b).

[21] See I.R.C. § 954(a).

[22] See I.R.C. § 954(d)(1).

are designed to subject to current taxation the income of CFCs primarily engaged in selling, as opposed to manufacturing or similar activities.

In applying the foreign base company sales income rules, the income of a branch operation outside the CFC's country of incorporation is treated as foreign base company sales income of the CFC when use of the branch has substantially the same tax effect as if the branch were a wholly-owned subsidiary.[23] The Treasury Income Tax Regulations set forth detailed rules for making this determination with respect to both sales and manufacturing branches. The effect of this procedure is to prevent avoidance of tax by United States shareholders on income which in substance is identical to foreign base company sales income where the existence of such income would not otherwise be recognized because of formal unity of a CFC and its branch as a single corporate entity.[24]

Legislative chronology of subpart F

In accordance with the legislative history of Subpart F under the Revenue Act of 1962, it is clear that the United States Congress adopted the percentage of voting power test contained in Section 957 (pertaining to the definition of a controlled foreign corporation) and specifically rejecting percentage of value and effective control tests, recognizing that United States shareholders should only be taxed currently on undistributed foreign corporate profits where such shareholders possess sufficient power to cause payment of dividends.

An anlaysis of the specific legislative chronology on this matter reveals the following:

(1) Treasury Department's orginial proposal to tax United States shareholders currently on undistributed earnings of foreign corporations was rejected by Congress as overreaching.

(2) In a second and narrower proposal, the Treasury Department pressed Congress to adopt a definition for CFCs which would be based on either a value test or a voting power test (it should be noted that the Congress, on its own initiative, did not consider a test beyond a voting power test).

(3) Despite the suggestions and arguments of the Treasury Department, the Congress selected the voting power test to determine CFC status.

(4) The Congress concluded that United States shareholders should not be taxed on undistributed earnings of a foreign corporation unless such shareholders has the requisite voting power to cause the declaration and payment of dividends.

(5) The Congress was aware of other types of test for determining CFC status, such as percentage of value, practical control, effective control, etc. (the Congress had often used such various control tests either individually or in combination to remedy specific problems) and therefore, it is particularly significant that the Congress did not select any test other than that of voting power for the CFC definition.

House Ways and Means Committee hearings

It is important to recognize that early in the process of the legislative history of Subpart F, various members of the House Ways and Means Committee expressed concern about the apparent approach of the Treasury Department regarding standards for the definition of a CFC. Apparently, the Treasury has hoped to give the newly-proposed taxing mechanism the broadest possible scope as demonstrated by its proposal that with respect to a corporation created after enactment of the legislation, any United States shareholder owning ten percent or more of the stock of a foreign corporation would be taxed on its share of the foreign corporation's earnings even though no other United States shareholder owned stock in the subsidiary, i.e. a 10 percent ownership test rather than a 50 percent ownership test would be applied to new foreign subsidiaries.

This approach attracted substantial opposition within the House Ways and Means Committee, and the Treasury Department withdrew the proposal and advanced another. The second Treasury initiative provided that a ten percent or greater United States shareholder would be taxed currently on its pro rata share of the foreign corporation's income only if five or fewer United States shareholders owned either (1) more than 50 percent of the voting power, or (2) more than 50 percent of the value, of the foreign corporation's stock.[25] Under this method, the Treasury's test of control was a two-pronged alternative test, i.e. ownership of either more than 50 percent in value or voting power would cause a foreign corporation to be classified as a CFC.

Again, key members of the House Ways and Means Committee expressed reservations about this type of control test. Senior Committee member Hale Boggs and

[23] See I.R.C. § 954(d)(2).
[24] See Treas. Reg. § 1.954-3(b).
[25] See U.S. Treas. Dept. Press Release D-186 (July 28, 1961).

ranking Republican member John Byrnes (recognized within the Committee as active and knowledgeable members in the foreign income area) doubted that the United States had the power to pierce the veil of foreign corporate entities in the manner proposed by the Treasury, despite Secretary of the Treasury Dillion's opinion that the manner in which United States shareholders of foreign personal holding companies were taxed established that the Treasury approach was legally proper. Accordingly, Congressman Boggs (who was not satisfied with Secretary Dillion's statement) asked that the staff of the Joint Committee on Internal Revenue Taxation prepare and submit a memorandum to the House Ways and Means Committee on this issue, such memorandum to be made an official part of the record of the hearings.[26] As noted below, this Joint Committee staff memorandum provides better evidence of Congressional intent on this issue than the pronouncements of the Treasury.

Treasury Department legal memorandum

In a legal memorandum from General Counsel of the Treasury Department Robert H. Knight to Secretary of the Treasury Dillon, it was the opinion of the Treasury Department that the subject Treasury proposal, including both the 50 percent threshold test for existing foreign corporations and the 10 percent threshold test for future foreign corporations, would be held valid under the United States Constitution both with respect to the taxing power and the power to regulate foreign commerce.[27]

Joint committee staff legal memorandum

The Joint Committee staff memorandum confirmed the basic concern and thinking of members of the House Ways and Means Committee, particularly on the question of the appropriateness under the United States Constitution of subjecting United States taxpayers to current tax treatment with respect to undistributed corporate income on the basis of constructive receipt: [28]

"*The administration's proposal is that the income earned by foreign corporations be taxed to the American shereholders without any distribution or dividend declaration. This raises certain basic questions as to whether or not the shareholder has income within the meaning of the 16th amendment when he has received nothing and does not have the right and power to demand any payment.*" [Emphasis supplied.]

The staff memorandum emphasized the separateness of corporate entities, even in the case of a United States subsidiary wholly-owned by a foreign government, and distinguished the Subpart F proposal from the foreign personal holding company provisions which were described as a special case which must be viewed as depending on the power of Congress to prevent an obvious tax-evasion device. Finding no basis to justify current dividend-like taxation of undistributed foreign corporate earnings, the staff memorandum further concluded that the constructive receipt had no application because the United States shareholder had no power to declare a dividend and therefore lacked the power to demand the payment which makes the constructive receipt doctrine operative. Accordingly, the Joint Committee staff memorandum rejected The Treasury Department's contentions and adopted the view that only when a United States shareholder possessed the power to declare a dividend would the constructive receipt theory provide an appropriate basis for current taxation.

Statement of Special Committee for U.S. Exports

The Special Committee is a participating group of more than 1,200 business concerns and 80 supporting business associations whose operations and concerns are directed to the export of U.S. products. The Special Committee's major concerns are with the effect of the U.S. tax system on exports by U.S. businesses and the ability of those businesses to compete in foreign trade in view of the many tax advantages and incentives and direct and indirect subsidies provided to foreign competitors by their governments.

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[26] See Hearings on President's 1961 Tax Recommendations Before the House Ways and Means Committee, Vol. 1, p. 310, 87th Cong., 1st Sess., May 4, 1961.

[27] See memorandum prepared by the United States Treasury Department entitled, "Opinion re Proposal to Include in Gross Income of United States Shareholders Undistributed Earnings and Profits of a Controlled Foreign Corporation), June 12, 1961.

[28] See memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation entitled, "Constitutional Power to Tax Shareholders on Undistributed Income of a Corporation), p. 311.

Multilateral trade negotiations

Before discussing export tax incentives a comment on the Multilateral Trade Agreements presently before Congress is appropriate. The Agreements contain an Illustrative List of Export Subsidies which includes certain tax practices. The development of more specific rules regarding tax subsidies for exports is consistent with the intent of Congress when the Trade Act of 1974 was enacted.

However, due to the many issues addressed in the Agreements, portions are sómewhat vague and will require later clarifications and interpretations. Tax subsidies are clearly an area which will require interpretation.

The U.S. tax system has been modified a number of times in recent years to restrict potential U.S. tax benefits from export activities. In 1962 and 1964 Subpart F was added to the Internal Revenue Code which taxes in the United States for the year earned the income of certain foreign subsidiaries controlled by U.S. persons. The United States has also promulgated and vigorously enforced rules and regulations requiring transactions by a U.S. company with a foreign entity to be reported on an arms length basis under Section 482 of the Internal Revenue Code. The regulations governing the source of income and deductions under Section 861 of the Internal Revenue Code have been revised. Moreover, after various changes by Congress in and new interpretations by the Internal Revenue Service regarding the foreign tax credit over the last several years, the U.S. Treasury has issued new regulations in that area.

All of these actions have been carried out unilaterally by the United States to insure that there are no tax advantages from export sales. Other nations have failed to adopt similar provisions in their tax systems and in many cases have used the so-called "loopholes" which have been closed in the U.S. systems as a mechanism to encourage exports.

The one significant U.S. export tax incentive is DISC, which was enacted in 1971. Congress purpose in enacting DISC was to a large extent to offset the many foreign tax incentives including rebate of value added taxes, the territoriality system under which foreign earning are not taxed, the lack of arms length standards, etc.

DISC along with various tax practices of other nations was considered by GATT panels for several years and GATT documents L/4422, L/4423, L/4424 and L/4425 were published on November 2, 1976, questioning the appropriateness of various tax practices. The new Multilateral Trade Agreements do not address these issues directly but the import is that such practices will be subject to further evaluation under the new codes. While U.S. exporters are encouraged by Administration assurances that the new codes will have no impact on the DISC program, the Special Committee continues to believe that clarification should be sought in the broad area of tax subsidies.

The Special Committee's view is that tax practices under the new Agreements should not be considered on a piecemeal basis. An international conference among the signatories would be a better way to proceed. At such a conference, tax practices and their subsidy affect on exports could be considered jointly and in detail.

The Special Committee urges that the Congress include in the implementing legislation an expression of the consensus of the U.S. Congress that an international conference to consider tax subsidies be held after the ratification of the Multilateral Trade Agreements by the various signatories.

This step should lead to greater clarity with regard to what are acceptable tax incentives. Such clarity will be beneficial to the Congress in shaping legislative tax incentives for exports.

Bills providing tax incentives for exports

The four Bills listed in the Subcommittee's announcement of hearings on tax incentives for exports would all assist U.S. exporters.

S. 231 would liberalize depreciation allowances for all U.S. taxpayers, including exporters, a step which would offset to some extent the benefits foreign competitors receive from depreciation allowances which are more liberal than the U.S. system. This problem has been widely recognized and documented both from the standpoint of making U.S. exporters more compeitive and from the standpoint of other factors such as capitol formation and offsetting the debilitating affects of inflation.

The Special Committee recognizes tht there are a number of proposals regarding liberalizing depreciation which are supported by its members. The Special Committee supports the concept of the various proposals but has not adopted a position supporting a specific proposal.

Two of the proposals, S 700 and S. 1065 provide incentives for research and development. Research and development are essential to the achievement of important national goals such as increased productivity and reduced inflation. It is also a

mainstay of keeping U.S. products competitive abroad. These proposals like S. 231 would benefit the U.S. economy as a whole and are supported by numerous members of the Special Committee.

The recognition in these three Bills that an essential ingredient of any export program is a healthy and therefore competitive U.S. economy is essential and an encouraging sign. Because the scope of proposals is broader than exports, the Special Committee, while supporting them in concept, has left it to member companies and supporting associations to adopt specific positions.

The remaining Bill, S. 1003, would provide more specific reserves for bad debt losses, reserves for losses due to currency fluctuations and clarify the treatment of certain expenses. This Bill is welcome in that it applies to exporters directly. It recognizes the need to offset the myriad of tax incentives provided by other countries to exporters.

The proposals in S. 1003 are technical in nature and impact on different companies in varying ways. Accordingly, the Special Committee while supporting the concept of such proposals has left it to member companies to analyze them more specifically.

We also note various other Bills which could be beneficial to exporters, such as S. 1254, S. 1255, S. 1256 and S. 1257 introduced by Senator Bentson. These Bills, similar to S. 700 and S. 1065 would stimulate productivity through incentives for research and development.

CONCLUSION

The Special Committee urges that and international conference be held to consider tax practices in order that permissable incentives can be distinguish from subsidies. In addition, the Special Committee supports proposals which would strengthen and increase the productivity of our economy.

Regarding specific export tax incentives, it is difficult to make specific recommendations while the Multilateral Trade Agreement is under consideration. Proposals such as those contained in S. 1003 would be helpful as immediate steps. However, if we are to be competitive and meet foreign competition benefiting from numerous export tax incentives, the Special Committee feels that a broader approach directly focusing on exports may be required. Such an approach should be simple to administer in order to make it attractive to small as well as large companies and permanent in nature in order that exporters may rely on the incentive.

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., July 3, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Committee on Finance, Washington, D.C.

TAXATION AND EXPORTS

DEAR MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE: The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment briefly to the distinguished Subcommittee on Taxation and Debt Management with respect to five bills that have been introduced for the purpose of spurring capital formation and exports. We request that these remarks be made a part of the public records in the current hearings on the bills in question—i.e., S. 231, S. 700, S. 935, S. 1003, and S. 1065.

Our principal purpose in writing at this time is to commend the sponsors of the bills under examination and to express our appreciation to the Subcommittee for providing a forum for active consideration of such measures. Over the years, as you may know, MAPI has done extensive original economic research and policy analysis as to both savings and investment generally and export policy in particular. (A partial listing of our recent research and analysis in these areas is attached.) We are extremely concerned about the current situation in both respects, and are now in the process of formulating recommendations for Congress to deal with what we believe to be the interrlated problems of insufficient growth of domestic fixed investment; high inflation; inadequate rates of productivity increase; the seemingly perpetual budgetary deficits; the mushrooming national debt; the declining U.S. dollar; and the persistent trade deficits that have, in part, prompted this hearing.

Although we are not currently in a position to present our own recommendations or to discuss the positive—and certain negative—aspects of the bills before the Subcommittee, we strongly endorse the general direction of the proposed legislation.

It is essential to a betterment of the U.S. economic position, in our opinion, that there be a prompt reduction and/or removal of the exising and worsening tax disincentives to fixed investment. Since the 90th Congress, speaking in general terms (and acknowledging some exceptions), we believe that the federal government has been inadvertently steering an economic "collision course" in its formulation of certain aspects of tax policy as it impacts on capital. Although there was some awakening to this fact in the 95th Congress, much more remains to be done to rectify past errors. The bills before you represent enlightened thinking, even though several have technical defects and/or do not accord with the pending trade legislation.

To preview our position, it will be based on the conviction that more national resources must be directed to private savings and investment. In part, this should be accomplished by reducing or eliminating certain existing tax impediments to capital formation, and that will be the focus of our recommendations. Our proposals will not be directed solely to "business" taxation because the saving and investment behavior of individual taxpayers is vital to the achievement of U.S economic objectives as well. In that connection, we recognize that any reallocation of resources among different classes of taxpayers could change relative tax burdens, which may be politically intolerable and might be senseless anyway if the "gains" for capital in one sector were to be offset by "losses" in another. Additionally, we believe that taxpayers of every category and income bracket must be given relief from the effects of inflation in raising their tax bills where there have been no real gains.

The Institute's position—as fully developed—will not be confined to tax incentives for export activity but will be much more encompassing. Also, it will recognize that taxation is but one of many elements which have contributed to the current U.S. economic situation, and that other federal government policies must be compatible with the objectives of any tax changes to be implemented. Moreover, our proposals will be formulated in an international perspective, with a view to making this country better able to hold its own in an increasingly competitive world. Finally, our recommendations on capital formation will be cost-effective to the best of our ability to predict savings and investment behavior within the usual parameters.

MAPI's developing views will be presented at the earliest practicable date consistent with economic conditions and the availability of this or another appropriate forum. Meanwhile, we again applaud the subcommittee for directing the spotlight of public attention at a relatively early date to fundamental issues that should be dealt with in the current Congress.

Respectfully.

CHARLES STEWART, *President.*

Attachment.

MAPI STUDIES DEALING WITH CAPITAL FORMATION, "REAL PROFITS," AND THE IMPACT OF INFLATION AND RELATED ACCOUNTING AND TAX ISSUES

(1) "Phanton Profits and Politics," by George Terborgh, April 1979.

(2) "The Performance of Fixed Investment Outlays in the Present Business Cycle," Capital Goods Review No. 109.

(3) "United States Productivity and Capital Formation," MAPI Memorandum G-107, April 4, 1979.

(4) "The Wage-Price Deceleration Program," by George Torborgh, January 1979.

(5) Taxation of Capital Gains, MAPI Statement, July 5, 1978.

(6) "Inflation and the Taxation of Capital Gains," by George Terborgh, March 1978.

(7) "Changing Theories of Fiscal Policy," by George Terborgh, April 1978.

(8) Corporate and Individual Tax Policy, MAPI Statements, March 6 and August 23, 1978.

(9) "The Minimum Tax on Tax Preferences—The Back-Door Route to Federal Tax Increases," March 1977.

(10) "Research and Development Spending in the Capital Goods Industries," MAPI Memorandum G-100, May 25, 1978.

(11) "Federal Anti-Inflation Policy," by George Terborgh, December 1977.

(12) "Corporate Earning Power in the Seventies: A Disaster," by George Terborgh, August 1977.

(13) "Unwinding the Present Inflation," by George Terborgh, March 1977.

(14) "Inflation and Profits," by George Terborgh, MAPI Memorandum G-70 of January 1974, Revised and Republished in July and December 1974, April and October 1976, April 1977, April 1978, and April 1979.

(15) "The Sad Story of Corporate Profits," by George Terborgh, March 1976.

(16) "A Mystery In Federal Profit Reporting," by George Terborgh, May 1976.

(17) "Inflation and the Taxation of Business Income," by George Terborgh, January 1976.

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

The Air Transport Association of America represent virtually all of the scheduled airlines of the United States. These privately owned companies make up the essential U.S. domestic and international air transportaion system. The airline industry, a high growth industry playing a vital role in the American economy, has a deep interest in tax policies designed to encourage economic expansion through increased private sector investment.

To maintain the air transportation system, the airline industry must commit to very heavy capital investment needs. Unfortunately, there is serious concern about its ability to meet those needs in the absence of special efforts to increase capital formation and to spur economic activity.

STATE OF THE AIRLINE INDUSTRY

Airline passenger traffic in 1978 increased 14 percent over the previous year of 1977. Some 274 million passengers relied on the airlines for business and personal travel last year, accounting for more than 84 percent of public inter-city passenger miles, and the airlines flew a record 5.7 billion ton miles of air freight service. The airline industry employs over 329,000 workers and operates approximately 2,300 aircraft which, together with supporting facilities and ground equipment, represents an investment of about $21 billion.

Total airline industry operating revenues in 1978 were approximately $23 billion. Industry reported earnings were $1.2 billion, or $440 million higher than 1977. However, while airline financial performance has been improving, low profit margins and huge investment needs present significant airline capital formation problems.

The airlines have made substantial strides toward improved earnings by expanding the air transportation market, by reducing costs, and by increasing productivity. For example, the average annual rate of growth of output per employee during the 1973-1977 period was 3.1 percent in the airline industry compared with only 1 percent for the rest of the business sector of the economy. This high level of industry productivity improvements is in large part due to the tremendous capital investment made by the airlines in aircraft technological development. Substantial future productivity gains are dependent on such advancements.

Aircraft technology advances traditionally have occurred at a very rapid pace. Consumers have benefited from the almost constant introduction of new, more productive aircraft enabling the airlines to keep fare increases lower than the price increases of other goods and services. These technological advances have also created and maintained many thousands of additional jobs in the aircraft manufacturing industry as well as the airlines themselves. But the cost of this technology to the airlines has been high, requiring an airline investment of $9 billion during the 1960's and $15 billion during the 1970's.

The large airline investments of the past two decades, however, pale in significance to those required during the 1980's. Because of continuing inflation, the large number of aircraft involved and the anticipated increased public demand for air transporation, it is estimated that the airlines will require between $75 and $100 billion in capital for aircraft acquisitions during the ten year period 1980-1989. This is a conservative estimate since more than 75 percent of the current airline industry fleet will need to be replaced before 1990.

While significantly improved airline earnings obviously will be necessary to compete with other industries for capital and investors, tax policies are also needed which will stimulate business activity, and encourage greater investment by the private sector. This need to achieve increased productivity is recognized by the proposed improvements in the capital recovery provisions of the tax code contained in bills S. 935 and S. 231 now before the Subcommittee.

DEPRECIATION GUIDELINES

The airline industry endorses Senator Chafee's amendment to the Internal Revenue Code contained in S. 935, which provides for an election to depreciate property eligible for ITC over 5 years and also allows the amortizations of pollution control equipment over two years. These measures would result in more rapid capital recovery and increased investment. Increased investment by U.S. industry is necessary to increase productivity and offset the effects of inflation. By accelerating the

recovery of capital, the U.S.A. Government will encourage the capital investment necessary for strong economic growth and increased employment.

ASSET DEPRECIATION RANGE

While the airline industry prefers the more innovative approach in S. 935, it also views the proposals contained in S. 231 to modify the ADR system for the purpose of stimulating business investment as a realistic alternative. This proposal would increase the range of allowable class life in the ADR system from 20 to 30 percent. Such an increase would be beneficial because the present 20 percent range requires substantially longer capital recovery periods than are appropriate or desirable with the current inadequate level of business investment. Moreover, present low levels of national productivity stem as much from capital recovery problems of this kind as from the availability of new capital. Broadening the depreciable life range would speed capital recovery significantly thereby effectively stimulating business investment.

CONCLUSION

There is general agreement on the need for tax policies designed to encourage increased private sector investment, employment and productivity. The recommendations of the airline industry, together with the bills being assessed by this Subcommittee, address this need and we urge that they be given favorable consideration by the Subcommittee.

STATEMENT BY JOHN F. MCDONNELL

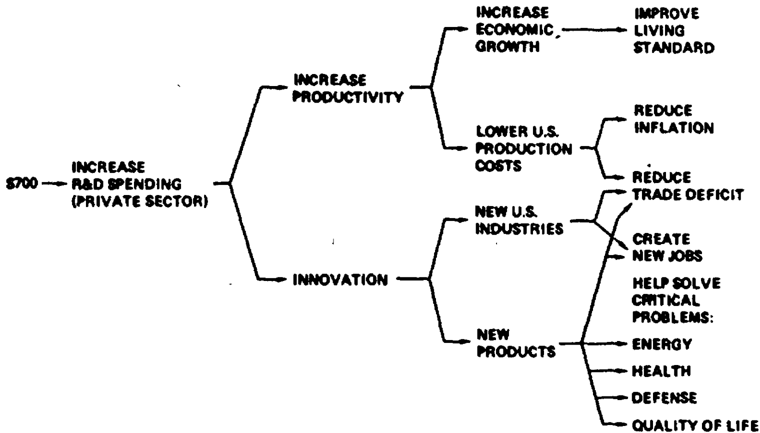
1. Introduction

My name is John McDonnell, Executive Vice President of the McDonnell Douglas Corporation of St. Louis, Missouri, a company primarily engaged in the development and manufacture of commercial aircraft, military aircraft, spacecraft, and missiles but also with some diversification in related fields. I appreciate the opportunity to submit a statement in support of S. 700 and S. 1065. This legislation has many beneficial effects, but most importantly it directly attacks two critical problems which currently trouble our nation. I refer to the unprecedented deficit in our foreign trade balance, which in turn weakens the position of the dollar in world financial circles, contributes to unemployment here at home, and is a major cause of the other problem, that is, inflation, which has been designated by President Carter as the Number One problem facing our country today.

2. S. 700

Turning first to S. 700, a bill extending the investment tax credit to certain research and experimental expenditures, there is a direct linkage between the increase in private sector research and development that results from the tax credit authorized by S. 700 and a spectrum of national goals. The various links in this chain are illustrated in Chart 1. In brief, as a result of S. 700, there will be an increase in research and development spending by the private sector. This in turn will produce an increase in both industrial productivity and innovation, giving rise to greater economic growth, lower production costs, new products for existing industries, and entirely new industries. These phenomena contribute to improved living standards and quality of life, to reducing the trade deficit and inflation, to creating new jobs, and providing for the national defense, improved health, and increased energy supply. I propose to discuss the several links of this chain of events separately,

CHART 1
A DIRECT LINKAGE BETWEEN THE RESEARCH TAX CREDIT (S700) AND PROGRESS TOWARD IMPORTANT NATIONAL GOALS INCLUDING REDUCING INFLATION AND THE TRADE DEFICIT



following which I will, as a representative of the aerospace industry, discuss the effect of this legislation on aerospace and other research intensive industries.

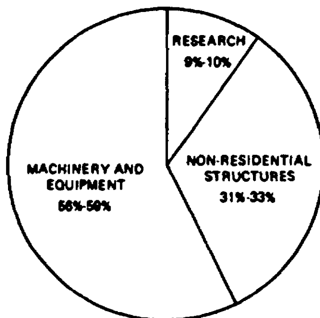
2.1 Effect of Investment Tax Credit on Private Sector R&D

First let us consider the effect of an investment tax credit on private sector research and development. All business investment may be divided into three categories: structures, machinery, and research and development. Chart 2 shows the distribution of total investment between the categories. As can be seen, machinery and equipment receives over half of the total, between 56% and 59%. Between 29% and 33% is allotted to structures, and research receives only 9% to 10%. The disproportionately small amount allotted to research is not surprising for this is by far the riskiest form of investment. The payoff for industrial R&D is usually deferred for many years and sometimes, of course, is

CHART 2

PRIVATE "INVESTMENT" IN THE U.S. - 1970-1976

RESEARCH +
CONVENTIONAL INVESTMENT: MACHINERY AND EQUIPMENT
NON-RESIDENTIAL STRUCTURES



Sources: Research expenditures (company funded R&D) according to the National Science Foundation. Machinery and equipment (producers' durable equipment) and non-residential structures according to the U.S. Department of Commerce.

never realized. The riskiness of research as an investment is illustrated in Chart 3, which describes typical investment programs in new commercial aircraft. Note that there is initially a very heavy cash outflow which may never be recovered and which certainly will not be recovered for many years after the initial investment. Commercial aircraft programs nearly always are in the red for as much as 10 years and many of them have never become profitable. While the experience of the commercial aircraft industry may not be typical, it does illustrate the profile of research investment in such other high technology industries as drugs, computers, chemicals, and instruments. In addition to the uncertainty of payoff, R&D, unlike the other forms of investment, has no resale value. Investment in structures or machinery, of course, provides the investor with a tangible asset which, if necessary, can be sold. Research and development does not. Moreover, because of the ever expanding rate of technological change, investment in research can be rendered obsolete prior to payoff. Here, again, there is a sharp difference between research and the other forms of industrial investment.

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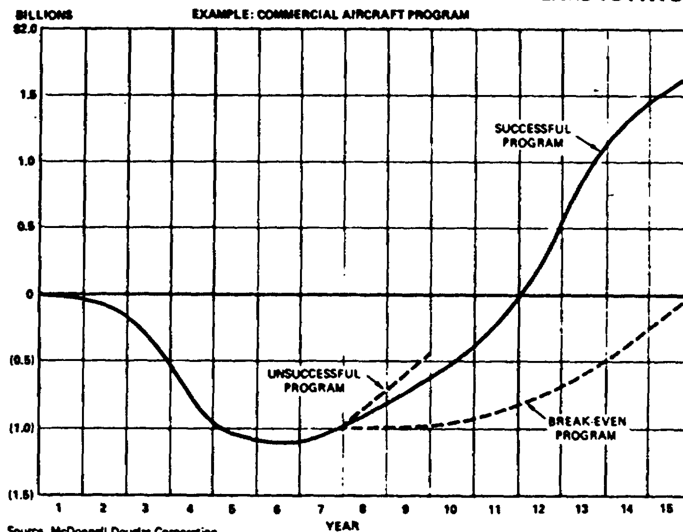
CHART 3
RESEARCH-INTENSIVE MANUFACTURING OPPORTUNITIES INVOLVE ENORMOUS EXPENDITURES BEFORE VOLUME SALES BEGIN AND MANY YEARS TO PAYOFF



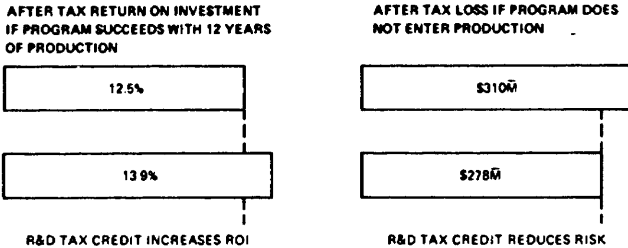
Parenthetically, I might observe that for manufacturing industries only, the share of total investment allotted to R&D is much higher than for industry as a whole. This is due to the fact that the manufacturing industries carry the full burden for all industry R&D. Most service industries invest little, if at all, in research. But even among manufacturers, R&D as a share of total investment has been declining - from 26% in 1972 to 24% in 1978.[1]

Having established that the risky nature of R&D has resulted in it receiving a very small share of total investment, let us consider whether a tax credit applicable to industrial research would increase its share of the investment total. The answer is emphatically affirmative. In Chart 4 we have illustrated the benefits of a 10% tax credit for research on a typical R&D investment program. Note that there is an increase in the return to the investor and a reduction of risk. An additional benefit, not

[1] As indicated in a figure on page 14, "National Patterns of R&D Resources"; National Science Foundation; 1978.

CHART 4

AN R&D TAX CREDIT WOULD ENCOURAGE AMERICAN BUSINESSES TO UNDERTAKE ADVANCED TECHNOLOGY PROGRAMS



Based on a typical commercial aircraft program as estimated by the McDonnell Douglas Corporation.

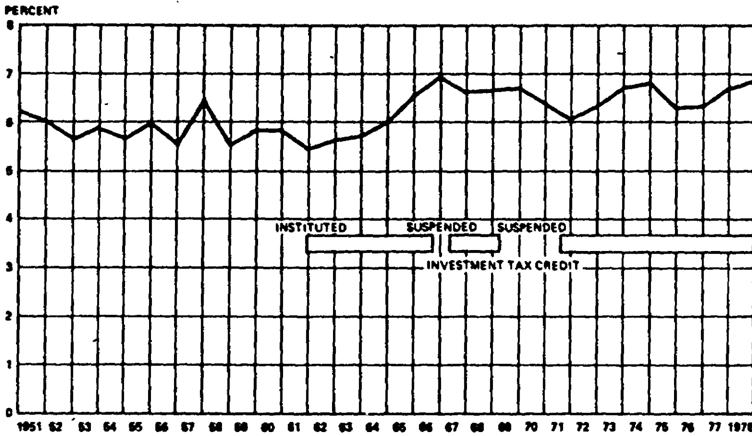
evident in the chart, is that the tax savings occur early in the program. The benefit to the investor is substantially enhanced by its up-front return. Manifestly this increase in ROI and reduction in risk enhances the attractiveness of the R&D investment.

Additional support for the favorable effect of the tax credit on R&D may be found in an analogy with the present investment tax credit on machinery. Machinery is by far the largest investment sector, possibly as a consequence of the fact that this is the only sector now benefitting from a tax credit. Also, periods of increased investment in machinery correlate closely with periods when the investment tax credit has been in effect. Chart 5 illustrates this point. As can be seen, investment in machinery and equipment as a share of the Gross National Product gradually declined through the 1950's. The effect of the investment tax credit is apparent in the watershed that occurred when it was first instituted in 1961; the share of the Gross National Product devoted to machinery and equipment reversed the decline and moved to a plateau much above the preceding decade. I believe that these data conclusively demonstrate the beneficial effect of the tax credit as an incentive for investment. It is reasonable to conclude that if this credit were extended to R&D a similar stimulation would result.

CHART 5

TAX INCENTIVES HAVE A CLEAR EFFECT AS IN THE CASE OF THE INVESTMENT TAX CREDIT FOR MACHINERY AND EQUIPMENT

MACHINERY AND EQUIPMENT: "PRODUCERS DURABLE EQUIPMENT" AS DEFINED AND TABULATED BY THE U.S. DEPARTMENT OF COMMERCE



Source: U.S. Department of Commerce.

Several developments of the past ten years make a research tax incentive far more necessary than in the 1950's or 1960's. The first such development is the quantitative change in private sector R&D. From 1953 through 1966, industry R&D, discounted for the effects of inflation, grew at an annual rate of 7.3%. In the subsequent 10 years, 1967 through 1978, growth dropped by more than one-half to an annual rate of 3.4%. (Chart 6).

A second recent development which accentuates the need for the research tax credit is the fact that the growth of private sector R&D has been declining, as pointed out above, at the very time when much of industry financed research and development is being diverted to non-productive purposes, that is, to the so-called mandated research requirements to improve worker safety and the quality of the environment. Data collected by the National Science Foundation indicates that research related to environment protection consumes 3½% of our national R&D effort.

CHART 6

THE DECLINE IN THE GROWTH OF RESEARCH EXPENDITURES COINCIDED WITH SLOWING GROWTH IN U.S. PRODUCTIVITY

	CONSTANT DOLLAR GROWTH RATE	
	INDUSTRY R&D EXPENDITURES	PRODUCTIVITY
1953-1966	7.3%	2.2%
1967-1976	3.4%	0.7%

Source: Industry R&D (company funded R&D) according to the National Science Foundation. Productivity (change in real GNP per employed civilian) according to the U.S. Department of Commerce.

One of the causes of decline in the growth of R&D is the uncertainty of present business conditions. The distinguished economist, Dr. Alan Greenspan, in a recent speech in St. Louis, pointed to the current level of inflation as the basic cause. He stated that a high level of inflation exacerbates the downside risk of all investments. A 1978 report by the American Association for the Advancement of Science echoes Dr. Greenspan's theory when it says that "industry, faced with inflation and uncertainty, is directing its research toward low risk and small scale projects with a quick payoff and toward modest improvement in existing products: there is less interest in major, long term, innovative developments."[2] Faced with the continuation of high levels of inflation, a tax incentive will be needed to overcome the reluctance of entrepreneurs to commit to risky R&D investments.

2.2 Effect of Increased R&D

The next step in our logic chain (Chart 1) concerns the effects of increased R&D. There are two primary effects: increased productivity and increased innovation. With respect to productivity there is much evidence to support the thesis that a principal source of productivity growth is R&D. For example, the National Center for Productivity and Quality of Working Life states: "Industrial R&D outlays tend to be positively correlated with productivity growth."[3] This observation is confirmed by the data in Chart 6. In fact, the thesis requires little proof. The result of industrial R&D is either improved processes or improved products.

[2] Quotation from page 29, "Productivity in the Changing World of the 1980's"; the final report of the National Center for Productivity and Quality of Working Life; Washington, D.C.; 1978.

[3] Page 27 of reference cited above.

The company which invests in research to improve its processes will be able to increase its output per unit of labor; i.e., improve its productivity. An ex~mple would be the present heavy investment within the aerospace industry in computer aided design and computer aided manufacturing. Extensive research in this field over a period of years has enabled aerospace to substantially increase output per unit of labor. Similarly, research and development on new products sold to other businesses enable those concerns to improve their product ivity. For example, IBM and other computer manufacturers' very heavy investment in various kinds of computers has also contributed to aerospace productivity improvements. Similarly, the increasingly efficient aircraft resulting from aerospace research enable the airlines to continue to improve their productivity.

Innovation is defined as "a new idea, method, or device". Research and development is the only systematic method of achieving innovation. Manifestly, the way to increase innovation is to increase R&D.

Moving to the third column of Chart 1, we observe the results of increased productivity and innovation. With respect to productivity, I will mention just two specific results: economic growth and lower production costs. It is particularly important at this time that we stimulate productivity as a means of insuring continued economic growth. For a number of years the growth of our economy has been sustained by a growing labor force. Even during the period of the 1970's, when growth in productivity fell to alarmingly low levels, national economic growth was sustained by strong increases in the size of the labor force. Past strong growth in the labor force, however, is not expected to continue. The number of young people annually entering the labor force has begun to decline, and will continue to do so throughout the eighties. Moreover, the strong boost to the labor force arising from the growing number of working women is approaching saturation. Thus the significant decrease in the rate of growth of our work force will denigrate this factor as a source of economic growth and the primary source must be an increase in productivity. Without an increase in productivity, there will be little, if any, economic growth. Without economic growth we will be unable to maintain the continuing rise in the standard of living which Americans have come to expect.

The relationship between research and development and economic growth has been demonstrated even more dramatically by Edward F. Denison of the Brookings Institution. In an article in the Brookings

CHART 7

FOLLOWING THE SLOWING GROWTH OF RESEARCH IN THE MIDDLE 1960'S, THE EFFECT OF ADVANCES IN KNOWLEDGE ON ECONOMIC GROWTH SWUNG FROM POSITIVE TO NEGATIVE

Sources of Growth of National Income per Person Employed, Nonresidential Business Sector

Percentage points

Item	1948-69	1969-73	1973-76	Change from 1948-69 to 1973-76 (1-3)
	(1)	(2)	(3)	(4)
Growth rate	2.6	1.6	–0.5	–3.1
Less irregular factors	–0.1	–0.5	0.1	0.2
Adjusted growth rate	2.7	2.1	–0.6	–3 3
Changes in labor characteristics				
Hours at work	–0.2	–0.3	–0.5	–0.3
Age-sex composition	–0.1	–0.4	–0.3	–0.1
Education	0.5	0.7	0.9	0.4
Changes in capital and land per person employed				
Nonresidential structures and equipment	0.3	0.2	0.2	–0.1
Inventories	0.1	0.1	0.0	–0.1
Land	0.0	–0.1	0.0	0.0
Improved allocation of resources	0.4	0.1	0.0	–0.4
Changes in legal and human environment	0.0	–0.2	–0.4	–0.4
Economies of scale from larger markets	0.4	0.4	0.2	–0.2
ADVANCES IN KNOWLEDGE and n.e.c.	1.4	1.6	–0.7	–2.1

Source "The Brookings Bulletin"; Fall 1978, in an article by Edward Denison.

Bulletin (Fall 1978) Denison describes an index which quantifies the economic effect of advances in knowledge. The index rose slightly from 1948 to 1973, then dropped from 1974 through 1976. The table in Chart 7 summarizes Denison's findings. He has estimated the separate effect of several factors that influence overall national income. Note that the last factor, "advances in knowledge and n. e. c. (not elsewhere classified)" shows the most adverse changes from a positive 1.4% to 1.6% prior to 1973 to a negative 0.7% thereafter. One way to put more knowledge to work, of course, is through the stimulation of private sector research. Denison's work, therefore, provides a compelling argument in support of S. 700.

A rise in productivity will also lower production costs. This in turn will provide the dual benefit of lowering prices - that is, reducing inflation - and also making American products more competitive in world markets. In my opinion, this direct impact on two of the nation's most severe problems is the strongest argument for the R&D tax incentive.

As noted earlier, in addition to stimulating productivity, increased R&D expenditures will contribute directly to innovation, the source of new products in existing industries, and also the basis for many entirely new industries. Television, jet travel, and the digital computers are three entirely new industries which were commercially nonexistent in 1945 but which by 1965 contributed more than $13 billion to the annual GNP and which provided an estimated 900,000 jobs.[4] Equally important, these new industries, growing out of innovative new products developed in the late 1940's and early 1950's, have made extremely important contributions to the quality of all our lives.

Both of these results of innovation - new products for old industries and entirely new industries - will contribute directly to the reduction of the trade deficit and to the solution of such critical national problems as providing an adequate national defense, better health care, and increasing the nation's energy supply. (Chart 1). I can think of no other way in which an equivalent amount of tax incentive could contribute directly to so many of our nation's major goals.

3. S. 700 and R&D Intensive Industries

Let us now consider the effect of S. 700 on R&D intensive industries, including aerospace. It is immediately evident that S. 700 will strongly benefit research intensive industries and these are the particular industries which lead in exports and will, therefore, make the greatest contribution to reducing the trade deficit.

[4]Page 4; "Technological Innovation: Its Environment and Management"; U.S. Department of Commerce; 1967.

Chart 8 ranks selected manufacturing industries in order of technology. Note the presence of aerospace, drugs, machinery, and instruments at the top of this list. Chart 8 also ranks these industries in terms of exports as a percent of sales. As can be seen, the industries which lead in exports also head the list with respect to R&D intensity. Clearly there is a relationship between the amount of money a company spends on R&D and the contribution it makes to exports. Chart 9 ranks industries in terms of Property Plant and Equipment as a percent of assets, in effect ordering the industries in terms of the benefit they receive from the present investment tax credit. The big exporters are at the bottom of this list, and consequently benefit the least from existing tax incentives. S. 700 will correct the inequity of present incentives and will provide a stimulant for additional R&D, thus increasing exports and decreasing the trade deficit.

CHART 8

HIGH TECHNOLOGY COMPANIES ARE LEADING EXPORTERS

INDUSTRIES RANKED BY TECHNOLOGY	SCIENTISTS/ENGINEERS PER 1000 EMPLOYES	INDUSTRY RANKED BY EXPORT ACTIVITY	EXPORT SALES AS PERCENT OF TOTAL
AEROSPACE	75	AEROSPACE	24.2
DRUGS AND MEDICINES	61	NON-ELECTRICAL MACHINERY	18.0
ELECTRICAL MACHINERY & ELECTRONICS	40	INSTRUMENTS	15.0
NON-ELECTRICAL MACHINERY	39	ELECTRICAL MACHINERY & ELECTRONICS	12.4
INSTRUMENTS	39	DRUGS AND MEDICINES	8.8
Industrial Chemicals	34	Motor Vehicles	8.4
Motor Vehicles	23	Industrial Chemicals	5.8
Rubber Products	20	Fabricated Metal Products	4.8
Petroleum Refining	19	Paper & Allied Products	4.7
Stone, Clay & Glass	12	Rubber Products	4.0
Fabricated Metal Products	11	Food & Kindred Products	3.3
Paper & Allied Products	10	Primary Metals	3.2
Primary Metals	8	Stone, Clay & Glass	2.9
Food & Kindred Products	7	Petroleum Refining	1.4

Source: 1976 data according to the National Science Foundation

Source: 1976 Industry Shipments data according to the U.S. Department of Commerce

CHART 9

HIGH TECHNOLOGY, EXPORT INDUSTRIES INVEST RELATIVELY LITTLE IN STRUCTURES AND MACHINERY AND CONSEQUENTLY RECEIVE LITTLE BENEFIT FROM THE INVESTMENT TAX CREDIT

	PLANT & EQUIPMENT PERCENT OF TOTAL ASSETS
Paper & Allied Products	48.9
Primary Metals	47.1
Petroleum Refining	46.4
Industrial Chemicals	46.3
Stone, Clay & Glass	45.4
Food & Kindred Products	33.5
Rubber Products	32.9
INSTRUMENTS	29.7
Fabricated Metal Products	27.9
NON-ELECTRICAL MACHINERY	27.1
DRUGS & MEDICINE	26.4
Motor Vehicles	25.7
ELECTRICAL MACHINERY & ELECTRONICS	23.1
AEROSPACE	17.0

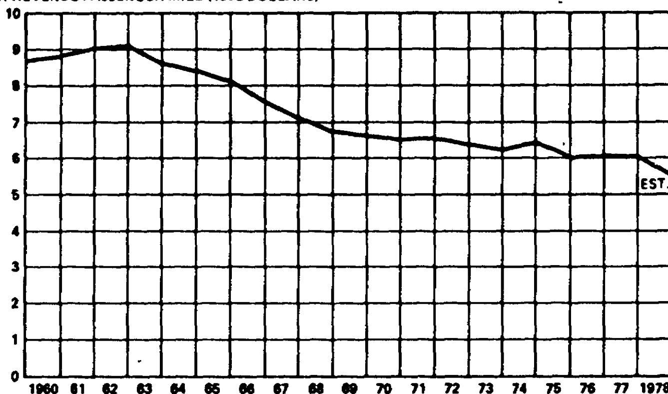
Source: 1976 data according to the Federal Trade Commission

Earlier in this statement I mentioned that industrial research focuses either on processes or products. Aerospace research is devoted largely to product improvement - toward the development of better and more efficient aircraft and other products. This concentration on product improvement has resulted in a continuing flow of ever more efficient aircraft to the airlines of the free world, enabling the airlines, and particularly U.S. airlines, through the years to reduce the cost - in real value - of air travel. This decline in the price the American public pays for air travel is depicted in Chart 10. It is one of the few truly counter-inflationary trends of the modern scene.

A final word about aerospace. U.S. commercial aircraft have dominated the free world market, constituting about 85% of the non-Communist world's total supply and making a massive contribution to the plus side of the U.S. trade balance. Recently this dominance has been threatened by Airbus Industrie, a manufacturer representing a consortium of nations with <u>much if not all of its development costs</u> paid by the parent

CHART 10

RESEARCH BY THE MANUFACTURERS OF COMMERCIAL AIRCRAFT HOLDS BACK THE COST TO THE FLYING PUBLIC



Source: Airline revenue data – Civil Aeronautics Board· U.S. Department of Commerce GNP Deflator.

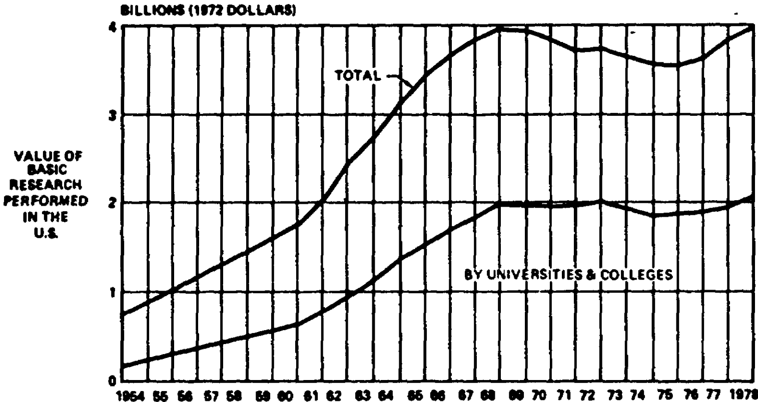
governments. S. 700 will - to a degree - offset the competitive advantages of Airbus Industries arising from government support.

4. S.1065

I will now comment briefly on S.1065, a bill to provide a tax credit to industries for contributions to university research. Industrial R&D is very heavily weighted on the development side. Few private companies have the resources to invest - on a continuing basis - in fundamental research not specifically aimed at the development of a marketable product. Yet it is basic research from which ultimately will emerge the scientific breakthroughs that result in entirely new products and businesses. Most basic research today is done at universities. (Chart 11). Since the middle sixties, basic research has been on a plateau, with little or no increase in real value. One way

CHART 11

THE SOURCE OF ENTIRELY NEW PROCESSES AND PRODUCTS — BASIC RESEARCH — HAS BEEN ON A PLATEAU SINCE THE MIDDLE 1960'S



Source: National Science Foundation.

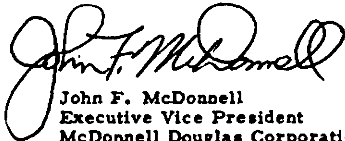
of increasing basic research would be to stimulate contributions from industry for university research. S.1065 is designed to provide this stimulation and in my view will succeed in doing so.

While it is more difficult to show a direct relationship between basic research and the achievement of national goals, as I have done for applied research in earlier sections of this paper, it is generally agreed that without a strong basic research program, applied research will eventually run out of steam. Both basic research and applied research are necessary to a healthy balanced R&D program. S.700 and 7.1065 are complementary, therefore, providing needed stimulation to both basic and applied research, the necessary components of successful Research and Development.

5. <u>Conclusion</u>

Numerous distinguished and diverse groups have endorsed the principle of a tax incentive for R&D. For example, the Joint Economic Committee, Congress of the United States, in its report on the January (1979) Economic Report of the President, states, "We urge consideration of additional tax and other incentives to promote industrial R&D."[5] Similarly the American Marketing Association in a public policy statement recommended "a Federal tax credit for research, similar to that provided for investments in plant and equipment."[6] My own analysis, as described in the preceding portions of this statement, strongly supports the position that tax incentives for R&D, as embodied in S. 700 and S. 1065, will significantly contribute to accomplishment of important national goals. I urge approval of this important legislation.

Respectfully submitted,



John F. McDonnell
Executive Vice President
McDonnell Douglas Corporation

[5] Page 22; Recommendation 26; "Report of the Joint Economic Committee, Congress of the United States, on the January Economic Report of the President"; March, 1979.

[6] As reported in the <u>Marketing News</u>; page 4, 10; June 20, 1975.

COLLINS & AIKMAN CORP.,
New York, N.Y., June 15, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Taxation and Debt Management Subcommittee, Senate Finance Committee, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: We are writing about an issue of great interest to this corporation and which your Senate Finance Committee Taxation Subcommittee will soon be considering * * * export incentives. We have learned that bills providing changes in depreciation rules (S. 231), tax credits for applied and basic research (S. 700 and S. 1065, respectively) and deductions for foreign bad debt losses (S. 1003) will be the subject of a hearing on June 18th. We would like to take this opportunity to endorse the goals which these bills seek to attain.

Our textile and wallcoverings industries can accrue significant benefits from greater exposure in and ease of entry into export markets. But as you are aware, the costs and risks are high. Therefore, we are most interested in the two bills which may reduce our risk and ease the burden of investment to increase productivity.

S. 1003 appears to provide reasonable provisions to soften the blow from bad debt and currency translation losses. Changes to the 15 percent tax on export income or 2 percent tax on outstanding export credits and the deduction for currency fluctuations would be beneficial. It is wise that this bill clears up the ambiguities regarding the deductibility of foreign market studies, expenses and patents. At the same time, we are concerned about proposals for a special reserve for credit losses which will add to the funds tied up in credit provisions. While we are prudent enough to make allowances for such losses, we do not see a need for a law to mandate such a practice.

Acceleration of depreciation has been a long-standing interest of ours because we need to be able to recover our extraordinary capital investments more quickly. S. 231 would provide an important start and would allow us to make greater investments in penetrating foreign markets.

The idea of tax incentives for research is good and can be very helpful. S. 700 and its provision for a 10 percent credit for expenses related to applied research is well-advised, if not modest. Provisions included in S. 1065 for calculating the 25 percent credit for contributions for basic research appear to dilute the intended benefit and should be reconsidered and deleted.

Overall, the subcommittee has a golden opportunity to advance the cause of greater U.S. exports. This can be very important to Collins & Aikman, its employees, your constituents and the Nation.

Cordially,

PETER J. ALCALY, *Director of Taxes.*
LEONARD M. STABILE, *Export Manager.*

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 ROCKEFELLER PLAZA • NEW YORK, N. Y. 10020 • (212) 581-6420

July 27, 1979

Mr. Michael Stern
Staff Director
Finance Committee
2227 Dirksen Senate
Office Building
Washington, DC 20510

Dear Mr. Stern:

The Senate Finance Subcommittee on Taxation and Debt Management held hearings on several bills on June 18, 1979 which would provide tax incentives for exports. The Administration objected to those bills. Subsequent to the hearings, S.1435, the "Capital Cost Recovery Act of 1979," was introduced by Senators Nelson, Bentsen, Packwood and Chafee. The National Foreign Trade Council has prepared a statement in support of that bill, which we have enclosed.

Sincerely,

Carter L. Gore

Carter L. Gore
Director
Tax/Legal Division

CLG:acf

Enclosure

Founded in 1914, the National Foreign Trade Council, Inc. is a private non-profit organization for the promotion and protection of United States international trade and investments.

Tax Incentives For Exports

The National Foreign Trade Council, a non-profit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment, is pleased to submit comments on tax incentives for exports. The Senate Finance Subcommittee on Taxation and Debt Management held hearings on several bills on June 18, 1979, namely S.231, S.935, S.700, S.1003 and S.1065, which would grant various tax incentives.

We concur in the statement contained in the announcement of the hearing that "the time has come to get serious about an export policy." A program to stimulate export expansion is essential in view of the high cost of energy imports and the magnitude of recent trade deficits. We further believe that tax and other incentives to increase exports must be applicable to large, as well as medium size and small firms, for the reason that large firms account for and are likely to continue to account for the majority of the nation's exports.

American plant and equipment is becoming obsolete, productivity is declining, and we are losing our competitive edge in the world marketplace. The United States share of the world export market has declined from 20% in 1960 to 14% in 1978. The research and development needed to increase productivity has become more costly as inflation has increased and the returns for those expenditures have therefore declined.

Both restrictive regulations (environmental, health and safety) and tax policies have combined to further reduce the incentives for additional research expenditures. In addition, a great portion of American research effort must now be devoted to pollution control and safety of new products. While we believe this effort is worthwhile, it is being made at the sacrifice of bringing new products and techniques to market. If American industry does not become more efficient, it must raise prices to compensate for increasing costs, making our products less competitive abroad.

In contrast to American industry, our foreign competitors are generally confronted with less restrictive regulations and frequently are able to obtain government aid in the form of tax incentives or outright subsidies for research and development. Therefore, they have been able to manufacture new products at lower costs.

We understand that the Administration objected to the bills under consideration as being "narrowly targeted programs" that may violate the spirit, and perhaps the letter of the Multilateral Trade Negotiations. In addition, the research and development proposals, S.700 and S.1065, would raise a "number of difficult administrative and definitional issues." Furthermore, the Administration found the revenue cost of S.231 and S.935 to be prohibitive at this time.

We believe that the United States should enact tax legislation that will improve America's position in the world marketplace, increase productivity and reduce unemployment and inflation. This requires that the Federal government, consistent with the Administration's policy of according a high priority to revitalization of our export trade, adopt programs which will create an economic climate in which investment, including investment in research and development and innovation, by businesses large and small, can thrive and prosper.

These objectives can be best accomplished by increasing investment in more productive plant and equipment. The capital cost recovery provisions of S.1435 and H.R.4646 introduced June 27, 1979 would provide additional cash flow needed for investment in more productive plant and equipment. Adoption of these tax changes, resulting in improved capital formation, should significantly improve the worldwide competitiveness of U.S. industry.

July 27, 1979 National Foreign Trade Council, Inc.

[Whereupon, at 1:05, the subcommittee recessed, to reconvene at the call of the Chair.]

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